

SMALL BUSINESS INVESTMENT COMPANY  
PROGRAM

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A REPORT

OF THE

SUBCOMMITTEE ON SBA OVERSIGHT AND  
MINORITY ENTERPRISE

OF THE

COMMITTEE ON SMALL BUSINESS  
HOUSE OF REPRESENTATIVES



SEPTEMBER 21, 1976.—Committed to the Committee of the Whole House  
on the State of the Union and ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE

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(II)



## LETTERS OF TRANSMITTAL

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HOUSE OF REPRESENTATIVES,  
COMMITTEE ON SMALL BUSINESS,  
*Washington, D.C., September 21, 1976.*

HON. CARL ALBERT,  
*Speaker, U.S. House of Representatives,*  
*Washington, D.C.*

DEAR MR. SPEAKER: Transmitted herewith is a report of the Committee on Small Business entitled "Small Business Investment Company Program."

This report is submitted with the approval of the full committee.  
With kindest regards, I am

Sincerely,

TOM STEEDS,  
*Chairman.*

---

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON SMALL BUSINESS,  
SUBCOMMITTEE ON SBA OVERSIGHT  
AND MINORITY ENTERPRISE,  
*Washington, D.C., September 13, 1976.*

HON. TOM STEED,  
*Chairman, Committee on Small Business,*  
*U.S. House of Representatives,*  
*Washington, D.C.*

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on SBA Oversight and Minority Enterprise entitled "Small Business Investment Company Program."

This report is submitted with the approval of the subcommittee.  
With kindest regards, I am

Sincerely,

JOSEPH P. ADDABBO,  
*Chairman.*

LETTERS OF TRANSMITTAL

House of Representatives  
Committee on Small Business  
Washington, D.C. 20540

Honorable Member,

Enclosed for the Committee are two copies of a report of the Subcommittee on Small Business, dated and captioned as above.

I am, Mr. Chairman, transmitting herewith a report of the Subcommittee on Small Business, dated and captioned as above.

This report is submitted with the approval of the subcommittee.

Very respectfully,  
John S. Smith

Chairman, Subcommittee on Small Business  
House of Representatives

House of Representatives  
Committee on Small Business  
Washington, D.C. 20540

Honorable Member,

Enclosed for the Committee are two copies of a report of the Subcommittee on Small Business, dated and captioned as above.

I am, Mr. Chairman, transmitting herewith a report of the Subcommittee on Small Business, dated and captioned as above.

This report is submitted with the approval of the subcommittee.

Very respectfully,  
John S. Smith

Chairman, Subcommittee on Small Business  
House of Representatives

# CONTENTS

## CHAPTERS

	Page
I. Background and purpose of hearings.....	1
II. Summary of testimony.....	2
The need for venture capital and the congressional response.....	3
SBA financing of SBICs and MESBICs.....	10
SBIC and MESBIC financings of small business.....	17
SBIC and MESBIC industry characteristics.....	32
The business environment.....	47
Minority business environment.....	50
Government costs and benefits.....	53
III. Conclusions.....	55
IV. Recommendations.....	59

## EXHIBITS

I. SBA licensing activity of regular SBIC's and sec. 301(d) licensees (MESBICs).....	9
II. Obligations to SBA by private capital size distribution—Regular SBICs.....	11
III. Obligations to SBA by private capital size distribution—MESBICs (sec. 301(d) SBICs).....	12
IV. Regular SBIC leverage potential.....	12
Distribution of unused leverage.....	12
V. MESBIC (sec. 301(d)) SBIC leverage potential.....	12
Distribution of unused leverage.....	13
VI. SBA leverage by weighted interest rate, regular SBICs.....	14
VII. SBA leverage by weighted interest/dividend rate (percent), sec. 301(d) SBICs.....	14
VIII. SBA purchase of MESBIC (sec. 301(d) SBICs) debentures and preferred stock.....	15
IX. Number of small businesses financed by SBICs and MESBICs—Calendar 1975.....	20
X. Industry distribution of financings—SBICs (12 months ended March 1976).....	20
XI. Industry distribution of financings—MESBICs (sec. 301(d) SBICs) (12 months ended March 1976).....	21
XII. Types of financing provided to small businesses by SBICs and MESBICs.....	24
XIII. Size distribution of financing outstanding per business, regular SBICs.....	24
XIV. Size distribution, financing outstanding per business, MESBICs (sec. 301(d) SBICs).....	25
XV. Outstanding SBIC licenses as of March 31, 1966, by capital size.....	32
XVI. Regular SBICs private capitalization at time of license.....	32
XVII. SBIC survival rates.....	33
XVIII. MESBICs (sec. 301(d) SBICs) capitalization size at time of license.....	34
XIX. Regular SBIC, portfolio outstanding balances.....	35
XX. Size of investment per small business by SBIC size category.....	35
XXI. Financing type by SBIC size.....	35
XXII. SBICs—Statement of operations realized for 12 months ended SBIC fiscal year 1975 (based on 200 reporting SBICs).....	38
XXIII. MESBICs—Statement of operations realized for 12 months ended SBIC fiscal year 1975 (based on 29 reporting MESBICs).....	40
XXIV. Expense analysis based on 200 reporting SBICs—SBIC fiscal year 1975.....	41
XXV. Expense analysis based on 29 reporting MESBICs—SBIC fiscal year 1975.....	42
XXVI. Revenue statement for 12 months ended SBIC fiscal year 1975 based on 200 reporting SBICs, 29 reporting MESBICs.....	43
XXVII. SBIC program—Chargeoffs by fiscal year, by type of receivable.....	53
XXVIII. SBICs and MESBICs income earned by SBA by fiscal year.....	54

# CONTENTS

## CONTENTS

1	I. Introduction and general information
2	II. Summary of the financial statements and the consolidated financial statements
3	III. Detailed financial statements and the consolidated financial statements
4	IV. Financial statements and the consolidated financial statements
5	V. Financial statements and the consolidated financial statements
6	VI. Financial statements and the consolidated financial statements
7	VII. Financial statements and the consolidated financial statements
8	VIII. Financial statements and the consolidated financial statements
9	IX. Financial statements and the consolidated financial statements
10	X. Financial statements and the consolidated financial statements
11	XI. Financial statements and the consolidated financial statements
12	XII. Financial statements and the consolidated financial statements
13	XIII. Financial statements and the consolidated financial statements
14	XIV. Financial statements and the consolidated financial statements
15	XV. Financial statements and the consolidated financial statements
16	XVI. Financial statements and the consolidated financial statements
17	XVII. Financial statements and the consolidated financial statements
18	XVIII. Financial statements and the consolidated financial statements
19	XIX. Financial statements and the consolidated financial statements
20	XX. Financial statements and the consolidated financial statements
21	XXI. Financial statements and the consolidated financial statements
22	XXII. Financial statements and the consolidated financial statements
23	XXIII. Financial statements and the consolidated financial statements
24	XXIV. Financial statements and the consolidated financial statements
25	XXV. Financial statements and the consolidated financial statements
26	XXVI. Financial statements and the consolidated financial statements
27	XXVII. Financial statements and the consolidated financial statements
28	XXVIII. Financial statements and the consolidated financial statements
29	XXIX. Financial statements and the consolidated financial statements
30	XXX. Financial statements and the consolidated financial statements
31	XXXI. Financial statements and the consolidated financial statements
32	XXXII. Financial statements and the consolidated financial statements
33	XXXIII. Financial statements and the consolidated financial statements
34	XXXIV. Financial statements and the consolidated financial statements
35	XXXV. Financial statements and the consolidated financial statements
36	XXXVI. Financial statements and the consolidated financial statements
37	XXXVII. Financial statements and the consolidated financial statements
38	XXXVIII. Financial statements and the consolidated financial statements
39	XXXIX. Financial statements and the consolidated financial statements
40	XXXX. Financial statements and the consolidated financial statements
41	XXXXI. Financial statements and the consolidated financial statements
42	XXXXII. Financial statements and the consolidated financial statements
43	XXXXIII. Financial statements and the consolidated financial statements
44	XXXXIV. Financial statements and the consolidated financial statements
45	XXXXV. Financial statements and the consolidated financial statements
46	XXXXVI. Financial statements and the consolidated financial statements
47	XXXXVII. Financial statements and the consolidated financial statements
48	XXXXVIII. Financial statements and the consolidated financial statements
49	XXXXIX. Financial statements and the consolidated financial statements
50	XXXXX. Financial statements and the consolidated financial statements

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SEPTEMBER 21, 1976.—Committed to the Committee of the Whole House on the  
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Mr. STEED, from the Committee on Small Business,  
submitted the following

### REPORT

#### SMALL BUSINESS INVESTMENT COMPANY PROGRAM

##### CHAPTER I. BACKGROUND AND PURPOSE OF HEARINGS

The Subcommittee on Small Business Administration Oversight and Minority Enterprise, chaired by Representative Joseph P. Addabbo (D. N.Y.), conducted hearings on July 20, 21 and 22, 1976, to investigate certain Small Business Administration programs and activities designed to augment the availability of capital to small business concerns.

In addition to Chairman Addabbo, the subcommittee is comprised of the following members: Representative James M. Hanley (Democrat of New York); Representative Fernand J. St Germain (Democrat of Rhode Island); Representative Henry B. Gonzalez (Democrat of Texas); Representative Frederick W. Richmond (Democrat of New York); Representative Alvin Baldus (Democrat of Wisconsin); Representative John Breckinridge (Democrat of Kentucky); Representative Thomas J. Downey (Democrat of New York); Representative Tim Lee Carter (Republican of Kentucky); Representative William F. Goodling (Republican of Pennsylvania); and Representative Hamilton Fish, Jr. (Republican of New York).

Representative Tom Steed, Democrat of Oklahoma, Chairman of the full Committee, and Representative Silvio O. Conte, Republican of Massachusetts, Ranking Minority Member, are *ex officio* Members of the Subcommittee.

Subjects under review during the hearings were the Small Business Investment Company and the Small Business Lending Company pro-



grams, as well as the "SBA Plan for Action" recently submitted to the Committee Members by Administrator Mitchell P. Kobelinski. Each of the programs and activities investigated have for their common theme the use of Government inducements to attract private resources into the Nation's small business community. We therefore view these and similar efforts to be of paramount concern. If we fail to leverage private resources for the purpose of redirecting their economic impact to small business, we shall relegate the function of our economy to a select group of dominant business concerns and interests. Our statutes are replete with references to an economy predicated upon the vitality of small business concerns. The Subcommittee conducted the subject hearings in an attempt to determine the measure by which certain SBA programs have transformed these expressions of ideals into tangible realities for small business persons. Without addressing the problems associated with capital formation all other efforts geared to advance the position of small business are rendered of speculative value.

Circumstances strongly suggest that the SBIC program be afforded a priority of concern by this Committee. Consequently, this report is exclusively devoted to that subject.

## CHAPTER II. SUMMARY OF TESTIMONY

In his opening statement Chairman Addabbo commented, "The Subcommittee is mindful that the investment policies and practices of SBICs are not uniform. In fact, we believe that no one SBIC may be labeled as 'typical.' We further realize that the venture capital 'industry,' if it may be legitimately called an industry, often escapes precise definitional boundaries." In recognition of these considerations the Subcommittee actively solicited and received testimony from a rather divergent group of interested parties.

Relative to the SBIC and MESBIC program (for the purposes of this report the term "MESBIC" and "section 301(d) licensee" will be used interchangeably) testimony was received from: The Small Business Administration, by its Administrator, Mitchell P. Kobelinski; Dr. John L. Komives, President of Lakeshore Group, Ltd.; FNCB Capital Corporation, the largest SBIC in the program, by its President, Russell L. Carson; Schooner Capital Corporation, represented by its President, Vincent J. Ryan; John O. Flender, Treasurer of M.I.T. Development Foundation, Inc.; Pennsylvania Growth Investment Corporation, by William H. Tritsch, Executive Vice President and Director; the National Association of Small Business Investment Companies, by its President, David Engelson; the Office of Minority Business Enterprise, Department of Commerce, by its Director, Alex Armendaris; Dr. Kenneth E. Knight, Professor of Management, University of Texas at Austin; Gulf South Venture Corporation, represented by Robert P. Aulson III, President, Chief Executive Officer and Director; CEDCO Capital Corporation, by Joseph W. Miller, General Manager; the American Association of Minority Enterprise Small Business Investment Companies, by Walter W. Durham, President and Reginald F. Lewis, General Counsel; and Space Ventures, Incorporated, which did not appear at the hearings but which offered a statement for the record by its President, M. R. Dahn.

The Subcommittee believes that the testimony elicited adequately represents the spectrum of views to be considered and summarized that testimony as follows:

#### THE NEED FOR VENTURE CAPITAL AND THE CONGRESSIONAL RESPONSE

The term "venture capital" is used to describe a type of investment which is distinguishable from the common form of debt financing obtainable through banks or similar types of financial institutions or equity financing available through traditional public underwritings. It is a term which is used without definitional constraints to describe a variety of investment activities. In fact, the Small Business Investment Act of 1958 speaks in terms of venture capital but it also fails to achieve any adequate degree of specificity. Section 303(b) states in part, "For the purposes of this subsection, the term 'venture capital' includes such common stock, preferred stock, or other financing with subordination or nonamortization characteristics as the Administrator determines to be substantially similar to equity financing."

Evidently, this statutory statement could not have been reasonably intended as an all inclusive listing of "things" which are venture capital, even if venture capital could be defined in such terms. It is apparent, however, that the SBA was to provide the operating guidelines. Pursuant to its rulemaking authority SBA has promulgated the following which appears at Title 13, Code of Federal Regulations, Section 107.202:

(b) "Venture Capital Financing" shall mean:

(1) Common and preferred stock and equity securities as defined in § 107.302(b) (2) with no repurchase requirement for five years, except as may be specifically approved by SBA under § 107.901 for purposes of relinquishing control over a small concern.

(2) Any right to purchase such stock or equity securities.

(3) Debentures or loans (whether or not convertible or having stock purchase rights) which are subordinated (together with security interests against the assets of the small concern) by their terms to all borrowings of the small concern from other institutional lenders, and have no part amortized during the first three years.

To read this definition one would believe that venture capital is nothing more than either a present or future equity interest or a subordinated debt. But the testimony clearly indicated that venture capital is a function of risk. In fact, Dr. Knight and his associate, Mr. Dorsey, stated that as much as 15% of all venture capital is lost to the investor. The type of security, by itself, is not a conclusive indication of the risk involved. This, by necessity, will vary with the peculiar financial condition of each potential investee. While it is generally true that equity and subordinated debt are risk investments, this is not, obviously, a universal tenet.

There is little doubt that the true venture capitalist would accept a risk that is unacceptable to a bank or similar type of financial institu-

tion. Since the potential yield on investment is a function of risk, we must assume that the venture capitalist (unlike a banker) expects that high return on a particular investment will more than offset losses which are also expected to be sustained on several other investments. From the testimony, therefore, we are advised that venture capital is high risk capital which is typically unavailable through public underwritings, or from the traditional banking community or similar institutions, and which is invested with full knowledge that it is, at best, a calculated chance.

As can be expected, there is no readily ascertainable formula whereby the Subcommittee can determine the precise need for venture capital over a certain time span. FNCB Capital Corporation, a wholly owned subsidiary of Citicorp, estimates that between \$250 million to \$500 million of "venture capital financing as common stock or equity oriented financing as opposed to debt financing" is needed per year. When Chairman Addabbo asked the SBA what they believe the need for venture capital is, Mr. John Wettach, Associate Administrator for Finance and Investment, stated:

There have been a lot of studies. . . . Data Resources, Inc., shows an investment need of \$4.4 trillion through 1985, of which \$2.9 trillion is business fixed investment. The New York Stock Exchange study, which created a lot of interest a few years ago, showed a \$4.7 trillion . . . need through 1985. Brookings has a different figure. They claim . . . \$2.0 trillion (is) needed for the rest of the seventies. But all of these figures are subject to a different interpretation—what they define as the need.

Of course, there is no method whereby the Subcommittee can determine what percent of the investment need, however defined, can be satisfied through the banking community, or through traditional public underwritings or, for that matter, through sources of venture capital. But, regardless of the uncertainty regarding specifics, there is general agreement of one fact. As stated by Mr. Wettach, "There is no question . . . that business, and especially small business, in our opinion is going to have a dramatic need for equity and venture capital over the next ten years."

Given the unanimous agreement of all witnesses that there is, in fact, a "dramatic" need for venture capital, the Subcommittee's subsequent inquiry was intended to elicit the sources of such financing available to the small business person. According to FNCB Capital Corporation, there is no organized venture capital industry "but there is an industry which consists of some of the larger SBICs, plus members of the National Venture Capital Association, plus a number of private families who," FNCB believes, "constitute what amounts to an informal venture capital industry. This industry has about 200 participants in it, and has assets of approximately \$2 billion." Others claim this industry is considerably larger. For example, Dr. Komives of Lakeshore Group Ltd., estimates that "there are some 600 equity financing firms available for growth oriented smaller enterprises."<sup>1</sup>

<sup>1</sup> The Subcommittee assumes that Dr. Komives equates the term "equity financing firms" with "venture capital firms."

The Subcommittee notes that while these firms have venture capital financing as a common purpose, there is great diversity in both their operation and emphasis. For example, Dr. Komives and Dr. Knight told of specialty type firms in the industry which restrict their financings to a particular type of business such as high technology, food retailing, oil and gas drilling, medical technology or franchise operations.

According to Administrator Kobelinski there are three principal sources of venture capital for small business. These are the private investment companies (non-SBICs), private savings of the individual business person (perhaps the "greatest" source of venture capital) and the SBICs, the subject of this report.

In 1958 Congress responded in part to the enunciated need of small business for additional sources of venture capital. In that year Congress passed the Small Business Investment Act which has for its stated objective the following:

It is declared to be the policy of the Congress and the purpose of this Act to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply: *Provided, however*, That this policy shall be carried out in such manner as to insure the maximum participation of private financing sources.

It is the intention of the Congress that the provisions of this Act shall be so administered that any financial assistance provided hereunder shall not result in a substantial increase of unemployment in any area of the country. (15 U.S.C. § 661.)

While the statement of policy quoted above does not indicate a preference of equity over debt, subsequent sections of the Act implicitly do so. A comparison of Sections 304 and 305 makes this evident. Section 304 reads in relevant part:

*It shall be a function* of each small business investment company to provide a source of equity capital for incorporated and unincorporated small-business concerns, in such manner and under such terms as the small business investment company may fix in accordance with the regulations of the Administration. (Emphasis supplied.)

Section 305, on the other hand, deals with long-term debt, and states in relevant part:

*Each company is authorized* to make loans, in the manner and subject to the conditions described in this Section, to incorporated and unincorporated small-business concerns in order to provide such concerns with funds needed for sound financing, growth, modernization, and expansion. (Emphasis supplied.)

As is evident, it is an unequivocal function of each SBIC to provide a source of equity capital for small business, but that a SBIC is merely



*authorized* to make loans. By the statutory language it appears that the latter type financing is of subordinate importance to the framers of the statute.

It should also be noted that Section 305(e) states, "Any loan made under this Section shall be of such sound value, or so secured, as reasonably to assure repayment." The obvious indication, therefore, is that the straight debt permitted under the statute is not in the nature of venture capital.<sup>2</sup> It is evident that the statute considers equity to be equivalent to venture capital (whether or not this is true in actuality) and that straight debt financing is an adjunct to this function to be used in limited circumstances.

Some SBICs implicitly agree that equity as opposed to debt is the focus of their statutory mandate. As stated by FNCB Capital Corporation, "To the extent that the SBIC industry is making debt rather than equity its predominant mode of investment it is deviating from its intended purpose of assisting small companies to grow and become stable economic entities."

While all SBICs are mandated to assist small business, MESBICs are intended to service a specialized need. In the late 1960's, the President's Advisory Council on Minority Business Enterprise viewed the SBIC program as an appropriate mechanism to channel financial and management assistance to minority business persons. SBA thereafter started to license a special class of SBICs known as MESBICs. The first MESBIC was licensed in 1969. "At that time," explained OMBE's Director, Alex Armendaris, "a goal of 100 MESBICs was established, each to be sponsored by a major corporation which would provide a one-time \$150,000 in capital funds, and \$50,000 per year in overhead coverage for staff, office, travel, etc." By 1972, 24 MESBICs were licensed and in that same year Congress gave the MESBIC program statutory existence. Public Law 92-595 amended the Small Business Investment Act by adding a new Section 301(d) which reads as follows:

Notwithstanding any other provision of this Act, a small business investment company, the investment policy of which is that its investments will be made solely in small business concerns which will contribute to a well-balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages may be organized and chartered under State business or nonprofit corporation statutes, and may be licensed by the Administration to operate under the provisions of this Act.

While the President's Council spoke in terms of minority business, the Congress elected to broaden the delineation to embrace all "socially or economically disadvantaged" persons. According to SBA Policy and Procedural Release No. 2017, dated July 1976, a MESBIC must undertake the following analysis to determine the eligibility of those small businesses seeking its financing:

<sup>2</sup> The Subcommittee is at a loss to reconcile the statutory language of § 305(e) with SBA's regulation, 13 CFR § 107. 202(b)(3), which defines venture capital financing to include subordinated debt when, by the terms of the statute, that debt must have a reasonable assurance of repayment.



## V. PROCEDURES RELATING TO ELIGIBILITY DETERMINATIONS OF DISADVANTAGED BUSINESSES

In determining whether small business concerns are socially or economically disadvantaged, reliance should not be placed upon a single factor, but on a composite of such factors as the social or economic background of the principal owners, controlling individuals and managers of the concern, along with the general pattern of their life, opportunities and education which have prevented them from obtaining financial or other assistance available to the average entrepreneur in the economic mainstream. Such persons may often include, but are not limited to Negroes, Indians, Eskimos, Aleuts, and persons of Mexican, Puerto Rican, Cuban, Filipino, or Oriental extraction. In determining whether the owners of small business concerns are "disadvantaged," consideration may be given to the following factors:

- (a) low income;
- (b) unfavorable location such as urban ghettos or depressed rural areas and areas of high unemployment or under-employment;
- (c) limited education;
- (d) physical or other special handicap;
- (e) inability to compete effectively in the marketplace because of prevailing or past restrictive practices; and
- (f) Vietnam era service in the Armed Forces, or such other factors as contribute to a disadvantaged condition in the ordinary (dictionary) meaning of that word: lacking in basic resources or conditions necessary to an equal society.

The impact of the SBIC and MESBIC program on the total demand for capital has been relatively slight. Administrator Kobelinski stated:

\*\*\* if we relate the financing disbursements of SBICs in any year to the total funds raised in the nonfinancial business sector in that same year (after first adjusting to 1972 purchasing power), the data indicate that *the SBIC's impact on or share of the total funds flow has deteriorated* \*\*\*. In 1967 the SBIC's disbursements accounted to 4/10 of 1% of the total funds raised in the nonfinancial business sector while in 1975 those disbursements were down to 3/10 of 1% of those funds in that year.

With specific reference to equity capital needs, Administrator Kobelinski concluded, "At best, SBICs have provided only a small tributary in the total flow of equity capital in the United States."

The authors of the Small Business Investment Act were also hopeful that, as explained by SBA, "The SBICs would be countercyclical in order to provide small business with the greatest portion of equity funds during periods of major economic decline and need." But, SBA continued, "the practicable incentives to allow SBICs to finance in this cyclical method were not provided by the Act." This observation was readily verified by FNCB Capital Corporation which described

the present SBIC industry as "highly cyclical, moving with the economy and the stock market. \* \* \*"

The business form which an SBIC or MESBIC may take is specified in the statute. A regular SBIC may be an incorporated body or a limited partnership (§ 301(a)). A MESBIC, on the other hand, must be a corporation and may be incorporated as a nonprofit organization (§ 301(d)).

Pursuant to Section 302(b) of the Act, an SBIC or MESBIC, may be wholly owned by a national bank or other member banks of the Federal Reserve System. Nonmember insured banks are eligible to purchase SBIC or MESBIC stock to the extent permitted under applicable state law. The statute further provides, however, that "in no event may any such bank acquire shares in any small business investment company if, upon the making of that acquisition, the aggregate amount of shares in small business investment companies then held by the bank would exceed five percent of its capital and surplus."

This bank ownership provision is found quite attractive by some banking institutions.<sup>3</sup> FNCB Capital Corporation, which is wholly owned by Citicorp, explained, "Our original interest in the SBIC program stemmed from it being the only legal manner by which Citicorp could enter the venture capital investment business." Banks cannot lawfully finance businesses through the direct acquisition of equity interests and, therefore, the SBIC program, we are told, is an available method whereby such institutions can "extend the range of financial services" to its business customers.

A person or organization wishing to form a SBIC or MESBIC must make application to the SBA for a license. Applications submitted must be accompanied by a \$500 "processing fee." Thereafter SBA will publish notice of the license application in the Federal Register to provide an opportunity for the submission of written comments. The information contained in the notice includes "the name and location of the proposed Licensee, its areas of operation, the names and addresses of its officers, directors, and owners of ten or more percent of its voting stock." (13 C.F.R. § 107.103) The prospective licensee must also certify to the SBA that it has published a similar notice "in a newspaper of general circulation in the city or proposed areas of operation." Once a license is issued it cannot be transferred or voluntarily surrendered without SBA's prior written approval (13 C.F.R. §§ 107.104 and 196.105). In addition, there are certain circumstances whereby SBA can initiate proceedings to revoke or suspend a license. The grounds upon which such action may be taken are specified in Section 309(a) of the Act:

#### REVOCATION AND SUSPENSION OF LICENSES

SEC. 309. (a) A license may be revoked or suspended by the Administration—

(1) for false statements knowingly made in any written statement required under this title, or under any regulation issued under this title by the Administration;

<sup>3</sup> The Small Business Investment Act Amendments of 1967 (P.L. 90-104) provided, among other things, that bank ownership of SBICs was limited to 49% of "any class of voting shares." This provision was recently repealed by P.L. 94-305, June 4, 1976.

(2) If any written statement required under this title, or under any regulation issued under this title by the Administrator, fails to state a material fact necessary in order to make the statement not misleading in the light of the circumstances under which the statement was made;

(3) for willful or repeated violation of, or willful or repeated failure to observe, any provision of this Act;

(4) for willful or repeated violation of or willful or repeated failure to observe, any rule or regulation of the Administration authorized by this Act; or

(5) for violation of, or failure to observe, any cease and desist order issued by the Administration under this section.

According to testimony received by the Subcommittee from the SBA, the agency evaluates three basic elements when considering an application for license. First, SBA will consider "a plan of action" submitted by the applicant which will contain the particular "thrust" of the organization, that is, the clients it wishes to serve and the marketability of the financial services proposed to be rendered. Secondly, the agency conducts a review of the financial resources of the prospective licensee, the amounts of private capital involved, as well as its source and possible conditions attached to its future expenditure. Lastly, SBA will carefully review, we are advised, the management skills and background of those individuals who own and will operate the organization. SBA's close scrutiny of personnel qualifications is cited by the agency as "one reason (why) the application process is lengthy."

The licensing activity of the SBA is summarized in the following Exhibit:

## EXHIBIT I

## SBA LICENSING ACTIVITY OF REGULAR SBIC'S AND SEC. 301(d) LICENSEES (MESBIC'S)

Calendar year <sup>1</sup>	Sec. 301(d) SBIC's		Regular SBIC's		Total	
	Number	Private capital	Number	Private capital	Number	Private capital
1959.....	0	-----	62	NA	62	NA
1960.....	0	-----	113	NA	113	NA
1961.....	0	-----	273	NA	273	NA
1962.....	0	-----	216	NA	216	NA
1963.....	0	-----	65	NA	65	NA
1964.....	0	-----	49	NA	49	NA
1965.....	0	-----	8	\$4,524,500	8	\$4,524,500
1966.....	0	-----	8	4,312,700	8	4,312,700
1967.....	0	-----	11	18,513,500	11	18,513,500
1968.....	1	\$350,000	7	14,263,895	8	14,613,895
1969.....	2	400,000	8	10,637,049	10	10,937,049
1970.....	19	3,541,116	6	7,418,000	25	10,959,116
1971.....	22	6,817,000	6	2,004,000	28	8,821,000
1972.....	14	4,982,102	8	3,572,949	22	8,555,051
1973.....	13	4,933,412	9	4,462,650	22	9,396,062
1974.....	10	4,600,070	16	17,002,840	26	21,602,910
1975.....	13	6,092,502	16	10,075,000	29	16,167,502
1976 (March).....	4	1,297,567	2	507,000	6	1,804,657
Total.....	98	-----	883	-----	981	-----

<sup>1</sup> Data prior to 1965 is unreliable with respect to private capital size at time of licensing.  
NA: Not available.

Since the inception of the program through March 1976, a total of 981 licenses have been issued, 883 for regular SBICs and 98 for MESBICs. As of July 31, 1976, there were 347 active licensees of which 81 are MESBICs and 266 regular SBICs.

The capital requirements prerequisite to the granting of a SBIC license are only generally specified in the statute. The subject provisions are found in Section 302(a) :

Each company authorized to operate under this Act shall have a combined private paid-in capital and paid-in surplus in an amount (1) not less than \$150,000, and (2) adequate to assure a reasonable prospect that the company will be operated soundly and profitably, and managed actively and prudently in accordance with its articles.

Administratively SBA has set a minimum of \$500,000 for the private paid-in capital requirement of regular SBICs. MESBICs, on the other hand, will be licensed at the \$150,000 level even though SBA strongly discourages "smaller capital situations."

Pursuant to rules and regulations SBA also imposes a restriction on the use of borrowed funds by persons wishing to invest in an SBIC or MESBIC. The restriction is found in 13 C.F.R. § 107.101(e) :

Shareholders owning ten or more percent of any class of Licensee's stock may not use borrowed funds in purchasing said stock, unless the net worth of such shareholders is at least twice the amount borrowed, or unless such shareholder obtains SBA's prior written approval of a lesser ratio on the grounds that it is adequate in light of all the circumstances."

As a general proposition private paid-in capital must consist of cash or eligible Government securities and cannot consist of borrowed funds.

#### *SBA Financing of SBICs and MESBICs*

The Small Business Investment Act authorizes the SBA to, in effect, finance or facilitate the financing of SBICs and MESBICs. Pursuant to Section 303 of the Act, when a SBIC or MESBIC cannot obtain necessary funds from private sources on reasonable terms, SBA is authorized to either purchase or guarantee SBIC or MESBIC debentures. These debentures are generally subordinate obligations and can be issued for a term not to exceed 15 years. Additionally, in the case of MESBICs only, SBA is authorized to purchase a certain amount of their nonvoting preferred stock which, by the terms of the statute, bear a three percent per annum cumulative dividend. The purchase price of these preferred stocks is set at par value and, in any one sale, must be \$50,000 or more.

The amount of financing provided by or through the SBA is dependent upon the private paid-in capital of the concerned SBIC or MESBIC. The financing is, therefore, referred to as "leverage." Regular SBICs with a private paid-in capital of less than \$500,000 may qualify for three dollars of leverage for every dollar of private paid-in capital. Those regular SBICs with private paid-in capital in excess of \$500,000 may qualify for a fourth dollar of leverage if "65 percent or more of its total funds available for investment in small business concerns (is) invested or committed in venture capital" financings.<sup>4</sup> (Section 303(b)(2)). According to the regulations, 13 C.F.R. § 107.202(c), the term "total funds available for investment shall mean ninety percent of the sum of total current assets and loans and investments in a cost basis net of current maturities . . ."

<sup>4</sup> A definition of "venture capital financing" is defined, supra p. 3.



The leverage provisions pertaining to MESBICs are somewhat more complex.

The amount of preferred stock which may be purchased by the SBA is fixed by Section 303(c) of the Act. The amounts purchased and outstanding at any one time cannot exceed:

(A) from a company having combined private paid-in capital and paid-in surplus of less than \$300,000 and licensed on or before October 13, 1971, the amount of combined private paid-in capital and paid-in surplus invested after such date, nor

(B) from any company having combined paid-in capital and paid-in surplus of \$300,000 or more but less than \$500,000, the amount of its combined private paid-in capital and paid-in surplus in excess of \$300,000, nor

(C) from any company having combined private paid-in capital and paid-in surplus of \$500,000 or more, the amount of its combined private paid-in capital and paid-in surplus.

SBA may also purchase or guarantee MESBIC debentures. For MESBICs with less than \$500,000 of private paid-in capital SBA may purchase or guarantee MESBIC debentures in an amount not to exceed 300% of its private paid-in capital *less* the amount of preferred stock outstanding pursuant to one of the three formulas mentioned above and for MESBICs with a private paid-in capital in excess of \$500,000 the total leverage, including preferred stock, cannot exceed 400%. However, in order to qualify for the fourth dollar of leverage the MESBIC must have at least 30% of its total funds available for investment invested or committed to be invested in venture capital financings.<sup>5</sup>

It should also be noted that the statute places a \$35,000,000 limitation on the total amount of debentures of any one regular SBIC which may be purchased or guaranteed by SBA. But, there is no similar dollar ceiling applicable to SBA's purchase or guarantee of MESBIC securities. In any event, according to testimony received from NASBIC, there are only about six regular SBICs which, at present, could theoretically reach this ceiling if fully leveraged.

As is evidenced by the following exhibits, through the leverage provisions of the Small Business Investment Act, SBICs and MESBICs have, on the average, more than doubled their capital.

#### EXHIBIT II

##### OBLIGATIONS TO SBA BY PRIVATE CAPITAL SIZE DISTRIBUTION—REGULAR SBIC'S

[As of Mar. 31, 1976]

Private capital size classification	Number of SBIC's	Private capital	Obligations to SBA	Total capital
\$300,000 or less	53	\$11,465,111	\$13,698,984	\$25,164,095
\$330,001 to \$1,000,000	125	64,732,294	89,632,538	154,364,832
\$1,000,001 to \$5,000,000	70	143,060,696	242,374,893	390,435,589
\$5,000,001 and over	15	174,299,097	124,750,034	299,049,131
Total	263	393,557,198	470,456,449	869,013,647

<sup>5</sup> There are special leverage provisions applicable to MESBICs regarding their use of nonprivate funds, see 13 C.F.R. § 107.101(d) (2).



## EXHIBIT III

## OBLIGATIONS TO SBA BY PRIVATE CAPITAL SIZE DISTRIBUTION—MESBIC'S (SEC. 301(d) SBIC'S)

[As of Mar. 31, 1976]

Private capital size classification	Number of SBIC's	Private capital	Obligations <sup>1</sup> to SBA	Total capital
\$300,000 or less.....	28	\$5,763,465	\$5,563,200	\$11,326,665
\$300,001 to \$1,000,000.....	46	28,124,079	32,760,957	60,885,036
\$1,000,001 to \$5,000,000.....	5	5,623,898	6,778,735	12,402,633
\$5,000,001 and over.....	0	0	0	0
Total.....	79	39,511,442	45,102,892	84,614,334

<sup>1</sup> Includes \$23,413,700 preferred stock.

The statutory provisions which allow the maximum four to one leverage in the case of venture capital SBICs were signed into law by the President on June 4, 1976. (P.L. 94-305). Prior to that time the maximum leverage for venture capital SBICs was set at three to one. Of course, it is too early to assess the impact of these new provisions. However, it is of interest to note the leverage potential under both the former and present statutory limitations.

## EXHIBIT IV

REGULAR SBIC LEVERAGE POTENTIAL <sup>1</sup>

[Dollar amounts in thousands]

	Total eligibility	Total remaining eligibility
New legislation.....	\$1,323,991.0	\$853,534.7
Old legislation.....	926,264.7	455,808.4
Net effect.....	397,726.3	397,726.3

<sup>1</sup> Assumes all companies with private capital greater than or equal to \$500,000 will qualify as venture capital SBIC's.

## DISTRIBUTION OF UNUSED LEVERAGE

Percent eligibility unused	New legislation		Old legislation	
	Number	Percent	Number	Percent
0 to 19.9.....	0	0	74	28.1
20 to 39.9.....	50	19.0	68	25.9
40 to 59.9.....	107	40.7	47	17.9
60 to 79.9.....	47	17.9	27	10.2
80 and up.....	59	22.4	47	17.9
Total.....	263	100.0	263	100.0

## EXHIBIT V

MESBIC (SEC. 301(d)) SBIC LEVERAGE POTENTIAL <sup>1</sup>

[Dollar amounts in thousands]

	Total eligibility	Total remaining eligibility
New legislation.....	\$148,971.9	\$103,869.0
Old legislation.....	109,460.5	64,357.6
Net effect.....	39,511.4	39,511.4

<sup>1</sup> Assumes all companies with private capital greater than or equal to \$500,000 will qualify as venture capital SBIC's.

## DISTRIBUTION OF UNUSED LEVERAGE

Percent eligibility unused	New legislation		Old legislation	
	Number	Percent	Number	Percent
0 to 19.9.....	0	0	9	11.4
20 to 39.9.....	9	11.4	12	15.2
40 to 59.9.....	13	16.5	17	21.5
60 to 79.9.....	38	48.1	26	32.9
80 and up.....	19	24.0	15	19.0
Total.....	79	100.0	79	100.0

Reference to the enabling legislation does not produce a ready answer for SBA disposition of SBIC or MESBIC securities.

According to testimony received by the agency, SBA has not purchased the debentures of regular SBICs since 1970. At present, such debentures are guaranteed "100 percent by the SBA (with the full faith and credit of the United States backing it with timely semi-annual interest payments assured)" and are then initially sold to the Federal Financing Bank, an entity of the United States Department of the Treasury. While the statute allows a term not to exceed 15 years, because of economic circumstances, a ten year term is much more common. Further, by the terms of the guarantee agreement, there are no prepayment provisions which accrue to such indebtedness.

Such debentures bear an interest rate which is specified in Section 303 (b) of the Act. The section provides, in relevant part:

Such debentures \* \* \* shall bear interest at a rate not less than a rate determined by the Secretary of the Treasury taking into consideration the current average market yield on outstanding marketable obligations of the United States with remaining periods to maturity comparable to the average maturities on such debentures, adjusted to the nearest one-eighth of 1 percentum, plus such additional charge, if any, toward covering other costs of the program as the Administration may determine to be consistent with its purposes.

Although the base interest rate on SBIC and MESBIC debentures are formulated on the basis of the same statutory provision quoted above, the rates are, in fact, determined differently. For regular SBICs rates are based on a spot Treasury new issue rate plus one eighth of one percent for Federal Financing Bank administration. Specifically, this method operates in the following way: on each Wednesday of the third full week of each month SBA will offer its guaranteed SBIC debentures to the FFB. The Department of the Treasury will then look to the bond market and obtain the Treasury yield curve of comparable maturities listed for the preceding day. Added to this is a new issue premium (which is subjectively determined) plus one-eighth of one percent for FFB administration. In June 1976 the rate on regular SBIC debentures, of a ten year term, was 8.025%. From 1970 to the present the weighted rate for all guaranteed SBIC debentures has ranged between 7.0% and 8.1%.

## EXHIBIT VI

SBA LEVERAGE BY WEIGHTED INTEREST RATE, REGULAR SBIC's <sup>1</sup>

Calendar year	Number of SBIC's	Amount (thousands)	Weighted interest rate (percent)
1970.....	139	\$59,566.2	7.285
1971.....	93	53,000.0	7.375
1972.....	49	38,560.0	7.000
1973.....	85	116,820.0	7.317
1974.....	44	42,300.0	8.122
1975.....	55	41,525.0	8.067
1976 (through June).....	13	9,510.0	7.946

<sup>1</sup> SBA leverage including applicable interest rates are not readily available prior to 1970. The amounts included herein total \$351,800,000 or 75 percent of the outstanding SBA leverage to operating SBIC's. We estimate that the interest rate on leverage furnished by SBA prior to 1970 is slightly below 6 percent per annum.

By virtue of Section 317 of the Act the SBA can *purchase* MESBIC debentures which, during the first five years of the term of such security, bear an interest rate which is the greater of either three percent or three percentage points below the interest rate determined under Section 303 (b) quoted previously. Because of this special purchase consideration, the Secretary of the Treasury determines the interest rate on such debentures differently than if called upon to purchase them as is the case with the debentures of regular SBICs. Here the Secretary of the Treasury will, on a monthly basis, send SBA a list of rates, for the previous month, of United States obligations of three, five, seven and ten year maturities. SBA will purchase the MESBIC debenture at a rate equal to the Treasury rate listing of United States obligations of comparable maturities. The three point differential specified in Section 317 is then applied to this rate for the first five years of the term.

Since 1970 the weighted interest rate of all SBA leverage provided to MESBICs is represented in the following exhibit:

## EXHIBIT VII

## SBA LEVERAGE BY WEIGHTED INTEREST/DIVIDEND RATE (PERCENT), SEC. 301(d) SBIC's

Calendar year	Number of SBIC's	Amount <sup>1</sup> (thousands)	Weighted <sup>2</sup> interest/dividend rate (percent)
1970.....	3	\$1,000.0	4.250
1971.....	5	1,550.0	3.137
1972.....	5	2,280.0	3.000
1973.....	27	12,260.4	3.851
1974.....	34	15,177.9	3.426
1975.....	22	10,284.5	3.528
1976 (through June).....	9	4,300.0	3.260

<sup>1</sup> Includes preferred stock purchase.

<sup>2</sup> At time of disbursement for first 5 years of term assuming earnings available for preferred stock dividends.

As is evidenced in the following exhibit, the predominant mode of MESBIC leverage is in the form of equity rather than debt:

## EXHIBIT VIII

## SBA PURCHASE OF MESBIC (SEC. 301(d) SBIC'S) DEBENTURES AND PREFERRED STOCK

Calendar year	Preferred stock purchases		Debenture purchases		Total	
	Amount	Percent	Amount	Percent	Amount	Percent
1970 .....	0	0	\$1,000,000	100.0	\$1,000,000	100
1971 .....	0	0	1,550,000	100.0	1,550,000	100
1972 .....	0	0	2,280,000	100.0	2,280,000	100
1973 .....	\$1,520,500	12.4	10,739,957	87.6	12,260,457	100
1974 .....	9,678,200	63.8	5,499,700	36.2	15,177,900	100
1975 .....	7,410,000	72.0	2,874,535	28.0	10,284,535	100
1976 (through June) .....	3,500,000	81.4	800,000	18.6	4,300,000	100

The statutory provisions which grant MESBICs special financing from the SBA are accompanied by a number of constraints which are found objectionable to most participating MESBICs.

Section 317 of the Act, which allows a reduced interest rate on MESBIC debentures for the first five years of the terms, also specifies that a MESBIC receiving this benefit cannot make *any distribution* to its stockholders (other than SBA) unless it first pays to SBA the difference between the special Section 317 rate and the normal rate computed by Section 303(b).<sup>6</sup> Further, SBA does not interpret this Section 317 as granting a pure subsidy of the interest rate for the first five years but requires the repayment of the difference between the Section 317 special rate and the Section 303(b) normal rate before the expiration of the term of the debenture. Testimony from OMBE, therefore, correctly characterized the Section 317 provisions as granting a deferral and not a subsidy which is repayable either at the time a MESBIC pays a dividend (or other distribution) to its stockholders or during the last year of the debenture, "whichever shall come first."

Similarly, the provisions referring to SBA's purchase of preferred stock have aroused considerable controversy.

Section 303(c) provides that upon liquidation or redemption of the preferred stock SBA "is entitled to the preferred payment of the par value of such securities." There is general agreement as to the need for this provision. However, the section continues, "and prior to any distribution (other than to the Administration) the Administration *may require* the preferred payment of the difference between dividends paid thereon and cumulative dividends payable at a rate equal to the interest rate determined pursuant to Section 303(b) for debentures with a term of fifteen years, without interest on such difference." (Emphasis supplied.)

The term "may require" has raised considerable uncertainty among MESBICs as to when the provisions of this section will be employed. SBA's regulation, 13 C.F.R. § 107.205(a) (2) (i), does not remedy the situation:

(2) *SBA's rights*—(i) *Payment of dividends to SBA.* Subject to the sound discretion of the board of directors, SBA shall be paid from retained earnings an annual three percent dividend on the par value of its preferred securities. Such

<sup>6</sup> See discussion *supra*, p. 13 et seq.



dividends shall be payable before any amount shall be set aside for or paid to any other class of stock, and shall be preferred and cumulative so that, in the event that SBA has received less than three percent in any fiscal year, such dividends shall be payable on a preferred basis from subsequent retained earnings without interest thereon. Before a declaration of dividends or any other kind of distribution (other than to SBA), SBA *in its discretion* may also require the preferred payment of the difference between dividends paid on its preferred securities, and cumulative dividends payable at a rate equal to the interest rate determined at the time of SBA's purchase of such preferred securities pursuant to section 303(b) of the Act for debentures with a term of fifteen years, without interest on such difference, such rate to be inscribed on the certificates offered to SBA. (Emphasis supplied.)<sup>7</sup>

As is evident from the foregoing, once a MESBIC avails itself of the special financing provisions contained in the statute there is little or no economic incentive for it to make a distribution to its shareholders.<sup>8</sup>

The American Association of MESBICs was most critical of SBA's interpretation of the Act and its failure to cure statutory ambiguities through its regulations.

With the present uncertainty of the Act and with no realistic expectation of any future return to our private sector shareholders, our ability to continue to attract badly needed private capital has been seriously undermined by SBA's ambiguous interpretation of the 1972 MESBIC legislation.

I think it is safe to say . . . that had the 1972 legislation been interpreted by SBA in the way both the SBIC and the MESBIC industry felt was intended, then a majority of the Fortune 500 corporations and major banks of this country would be investing in and supporting the MESBIC industry today, with perhaps \$100 million or more of private capital available to disadvantaged small business, and a much stronger and more viable MESBIC industry.

As a proposed remedy on this issue, AAMESBIC suggested the passage of legislation amending Section 317 to provide a true and permanent subsidy on the interest rate of MESBIC debentures for the first five years of the term. In addition, the Association recommended amending Section 303(c) to allow MESBICs to make distributions to its shareholders without paying SBA any differential cost because the agency holds its three percent preferred stock and, further, by making dividends cumulative only when earned.

<sup>7</sup> Further confusion is added by 13 C.F.R. § 107.205(a)(2)(iii) which provides in relevant part that before any distribution of assets to other stockholders, SBA shall be paid "any amounts due" pursuant to paragraph (a)(2)(i) which is quoted above. Reference to that latter paragraph indicates only such amounts are due as SBA may require "in its discretion."

<sup>8</sup> Consider, for example, a situation posed by OMBE where a MESBIC sells its preferred stock to SBA and then decides to make a distribution to its shareholders. According to the regulations, SBA may require the payment of the difference between 3% and a 15-year debenture with an interest rate determined in compliance with Section 303(b). This rate currently is in excess of 8%. In addition, dividends can only be paid from retained earnings which is an after tax figure. So that, in this hypothetical situation, the MESBIC wishing to make a distribution may have incurred a cost of at least 16% for the use of SBA's funds.



### *SBIC and MESBIC Financings of Small Business*

Of course, all statutory provisions previously discussed are geared to leverage private capital for the purpose of assisting small business. As with any SBA program, the Subcommittee's paramount concern is with the benefits derived by small business as compared with some quantifiable injection of assistance from the Federal Government.

We fully realize that the field of venture capital is highly specialized and may take as many forms as there are expressions of innovation in the financial world. We are, further, cognizant of the fact that SBICs and MESBICs are hybrid institutions created by government to service a specialized but legitimate national need. We are therefore dealing with a specialized subcategory of an already highly specialized and diverse field. The Subcommittee solicited and received testimony from a number of SBICs and MESBICs of differing characteristics in an attempt to best consider the spectrum of legitimate interests.

Generally, the SBIC and MESBIC witnesses indicated a variety of investment policies and practices. However, there were also evidenced some common areas of concern.

Pennsylvania Growth Investment Corporation, a SBIC licensed in 1962, and located in Pittsburgh, cited management capability and commitment as its most important consideration when evaluating a prospective investment. As stated by its Executive Vice-President and Director, William H. Tritsch:

Our direction flows from an investment philosophy built upon these principles:

Consider key people as the paramount element to be weighed in determining the quality of an applicant. In key people we look for (a) a pattern of success and (b) a positive entry into a business with a product line designed to fill a void in the market place. Our interest in an applicant is measured by the willingness of that applicant to commit his own savings to the venture. We give short shrift to those who introduce ventures too risky for their own bank accounts. The truest measure of an applicant's own faith in the venture is his personal commitment vis-a-vis his total savings rather than the magnitude of his participation in dollars. When the SBC achieves a reasonable measure of profitability, we believe it good business to offer SBC management the opportunity to purchase equity held by PGIC at a reasonable price and on extended terms. Such policy serves these purposes: (a) PGIC extracts a profit, (b) key people are more securely tied to the SBC, and (c) more investment opportunities open to PGIC as knowledge of its generous investment practices spreads.

When Chairman Addabbo asked the SBA what factors are evaluated before an SBIC or a MESBIC will make its financings available to a small business, he received a response which once again placed primary emphasis on management acumen:

Some of the factors being evaluated before an SBIC or MESBIC invests in a particular small business concern are as follows:

1. The management's length of experience in the business to be financed.

2. The management's awareness of the various problems usually associated with the business and management's ideas as to how to deal with them.

3. In a start-up situation, is management able and willing to invest its own money in the business.

4. Is management analytical as well as creative.

5. Management's understanding that timely financial reports are basic, necessary management tools.

6. Management's understanding that formalized marketing programs are important to the success of the business.

7. Management's willingness and ability to accept and utilize management and technical assistance.

8. Management's willingness to work closely with the SBIC or MESBIC to make and fit the pieces of the business puzzle needed to build a viable and profitable business.

9. Character, capital, credit history, and capability of Management.

Testimony from Dr. Komives, NASBIC and Mr. John O. Flender of M.I.T. Development Foundation, Inc., also indicated that SBICs and MESBICs prefer to invest in companies with some "track record" of past performance. As will be discussed *infra*, this has severely impacted the ability of "start-up" operations to secure necessary financing from SBICs or MESBICs.

There was a wide divergence of opinion as to the return on investment targeted as a goal by SBICs and MESBICs. OMBE stated that venture capitalists normally seek an 18% return. Pennsylvania Growth Investment Corporation attempts to double its investment within three to four years, although it was admitted that this target is seldom, if ever, achieved. FNCB Capital Corporation, on the other hand, stated that it expects a minimum return on a successful investment to be 25% pretax per annum with the bulk of this return realized as capital gains within five to ten years. There are still others who participate in the program for social reasons, such as Space Ventures, Inc., a MESBIC which is wholly owned by Rockwell International, which does not expect any profit at all and a return merely sufficient to cover operating costs and investment losses.

In some situations, the type of financing provided by an SBIC or MESBIC will also indicate the type of small business it will seek for its investments. For example, those SBICs specializing in equity financings will seek a firm with high growth potential, while those specializing in debt are most concerned with the financial ability of the firm to service that debt within the term of the debt instrument. However, many SBICs and MESBICs will provide debt coupled with a right to either convert to equity or purchase equity in the future to be exercised if the business should grow and prosper. Some examples of these differing policies follow.

FNCB Capital Corporation specialized in equity financing and stated its investment policy thus:

We will not make straight loans. All investments are either in common stock or in securities convertible into common stock or with options to purchase common stock.

The minimum expected return on a successful investment is 25% pretax per annum with the bulk of this return coming from capital gains realized upon the sale of our securities five to ten years after the original investment is made.

We prefer to invest in companies with unique technologies or proprietary services.

We prefer to invest in companies which have broad markets for their products or services and can grow rapidly to a size where public ownership of their securities is both desirable and feasible.

We will not invest in any business which does not have sophisticated, competent management with a meaningful equity stake in the business.

We are an active investor and expect to work closely with management to define and achieve common objectives.

We do not seek to control the businesses in which we invest and expect to divest our positions entirely with a ten to fifteen year period.

We recognize that we are in a high risk business and expect that a significant percentage of the investments we make will ultimately result in a partial or complete loss.

We recognize that losses generally occur in the first one to five years after investment while gains take five to ten years to materialize. We have been willing to accept early losses in our business with the expectation that we are simultaneously building future profits.

On the other hand, the First Connecticut SBIC, having a total capitalization of approximately \$22 million, is an example of an SBIC which has specialized in straight debt financings. According to its President, David Engelson, First Connecticut was formed for the predominant reason of becoming a lender. Therefore, its practices were "income oriented." As explained by Mr. Engelson:

From the outset, we have followed an investment strategy of making relatively small loans to firms located in our region and operating in an industry we knew something about. Furthermore, we have been an "income-oriented" SBIC, rather than a higher-risk venture capital investor, even though we have taken an equity position in many of our financings. At the present time I would estimate that 85% of our portfolio is in the form of term loans, with the other 15% consisting of debt securities, warrants, and stock.

However, as mentioned previously, the more common mode of investment seems to be a debt instrument (by "debt instrument" we mean interest bearing security) accompanied by a right to obtain an equity interest at the election of the investor. Gulf South Venture Corporation is one of many which have adopted this investment methodology: "A substantial portion of our portfolio investments," stated Mr. Aulston, President of Gulf South, "are in long-term subordinate

debt; however, we will convert this debt to equity when our return on equity is greater than our interest income."

Of course, there are a myriad of other factors which a particular SBIC or MESBIC may seek prior to making any one particular investment. As mentioned *supra*, some SBICs and MESBICs specialize in a particular business or industry and will, *pro forma*, deny its financings to all other concerns which are not so situated. Still others, will only invest in businesses with which the principals of the SBIC or MESBIC are thoroughly familiar. Finally, it is an apparently safe observation to say that each new investment opportunity is unique and SBIC policy barriers, whatever they are, may readily fall given any particular special set of circumstances.

Since the inception of the SBA and MESBIC program over 40,000 small businesses have been financed by these companies. This represents a total dollar disbursement to small businesses in excess of \$2.6 billion.

## EXHIBIT IX

## NUMBER OF SMALL BUSINESSES FINANCED BY SBIC'S AND MESBIC'S—CALENDAR 1975

	Total number small businesses financed	Total dollar amount of disbursements
1975:		
Regular SBIC's.....	1, 233	\$122, 700, 000
Sec. 301(d) SBIC's.....	256	13, 000, 000
To date (1958 through Mar. 31, 1976):		
Regular SBIC's.....	38, 780	2, 634, 100, 000
Sec. 301(d) SBIC's.....	1, 418	45, 700, 000

The industrial distribution of SBIC and MESBIC financings differ considerably. In the 12 month period ending March 1976, SBIC financing of manufacturing concerns accounted for 38.3 of the total dollar disbursements. The comparable percentage for MESBICs was only 15.6 percent. On the other hand, 44.4 percent of the dollars disbursed by MESBICs were utilized by retail and service establishments while these categories accounted for only 31.1 percent of disbursements by regular SBICs. The following exhibits detail the disparity between SBIC and MESBIC activity in most industrial categories.

## EXHIBIT X

## INDUSTRY DISTRIBUTION OF FINANCINGS—SBIC'S (12 MO. ENDED MARCH 1976)

	Number	Percent of number	Amount	Percent of amount
Agriculture, forestry, fisheries.....	17	1.0	\$938, 694	0.8
Mining.....	25	1.5	2, 959, 292	2.5
Construction.....	163	9.5	8, 834, 126	7.4
Manufacturing:				
Durable.....	9	.5	1, 199, 167	1.0
Non-durable.....	405	23.7	44, 861, 994	37.3
Transportation, communication, utilities.....	79	4.6	5, 324, 606	4.4
Wholesale trade.....	102	6.0	5, 998, 528	5.0
Retail trade.....	417	24.4	22, 826, 206	19.0
Finance, insurance.....	197	11.6	10, 802, 145	9.0
Services.....	273	16.0	14, 593, 274	12.1
Subtotal.....	1, 687	98.8	118, 338, 032	98.5
Unclassified.....	21	1.2	1, 809, 107	1.5
Total.....	1, 708	100.0	120, 147, 139	100.0



## EXHIBIT XI

INDUSTRY DISTRIBUTION OF FINANCINGS—MESBIC'S (SEC. 301(d) SBIC'S) (12 MO. ENDED MARCH 1976)

	Number	Percent of number	Amount	Percent of amount
Agriculture, forestry, fisheries.....	3	0.9	\$167,000	1.4
Mining.....	2	.6	100,000	.8
Construction.....	26	8.0	1,143,150	9.7
Manufacturing:				
Durable.....	3	.9	102,000	.9
Nondurable.....	58	17.8	1,746,871	14.7
Transportation, communication, utilities.....	16	4.9	524,000	4.4
Wholesale trade.....	55	16.9	1,141,972	9.6
Retail trade.....	79	24.3	2,792,975	23.6
Finance, insurance.....	20	6.1	1,454,352	12.3
Services.....	57	17.5	2,465,289	20.8
Subtotal.....	319	97.9	11,637,609	98.2
Unclassified.....	7	2.1	207,964	1.8
Total.....	326	100.0	11,845,573	100.0

As the two above exhibits indicate the "average" small business financed by a regular SBIC was engaged in manufacturing whereas the "average" MESBIC financed business was in the retail or service industry. According to the February 1976 *SBIC Digest*, published by SBA, the average age of a business financed by both SBICs and MESBICs during 1975 was under three years and the proceeds of the financings were used for operating capital.

The SBA Administrator stated that during 1975 there were approximately 5,000 businesses with outstanding SBIC investments. It should be noted that many of these businesses may have more than one financing from an SBIC or may have secured financing from more than one SBIC. The testimony indicated that in numerous situations SBICs expect that, once it makes a financing, it will be called upon to make additional capital infusions. For example, Pennsylvania Growth Investment Corporation testified that in most situations it expects to make more than one financing to a particular business, "whether it does well or poorly," and that a reserve is established for this purpose. The testimony from the witness on this issue can be empirically verified by industry wide statistics. As stated in the *SBIC Digest*, "First financings accounted for forty-three percent of the number of financings and fifty-four percent of the dollar amount of financing during 1975." Therefore, SBIC activity is rather equally divided between new and, what might be termed, "secondary rounds" of financing.

The financing which may be provided by an SBIC or MESBIC are subject to a number of constraints found in relevant SBA rules and regulations.

As a general rule all financings must be for a minimum period of five years except that a MESBIC may make financings for a minimum period of 30 months provided that the aggregate amount of financings for less than five years does not exceed 50 percent of the MESBIC's total portfolio at the end of any fiscal year (13 C.F.R. § 107.301(a)). (A financed business may also be charged a reasonable fee for prepayment if contained in the financing agreement.)

Short-term financing is permitted in three types of special circumstances. Section 107.504(b) (1) provides:



(b) \* \* \* A licensee may make the following investments in small concerns:

(1) Financing with a term of less than five years when it constitutes a reasonably necessary part of the overall sound financing of a small concern pursuant to the Act, the protection of investments, or financing ownership change pursuant to § 107.812. \* \* \*

While the above quoted provision also applies to MESBICs, Space Ventures, Inc. suggested the granting of more flexibility in this area:

The MESBIC should be provided with some flexibility to make short-term working capital loans. Presently, MESBIC's are restricted from making loans with terms under two and one-half years. Yet, the minority businessman often-times has a need for short-term working capital . . . to finance a new contract for example. The MESBIC could perform a valuable service if it could respond to this need. Therefore, it is suggested that a portion of a MESBIC's investment funds be authorized for use in making short-term or temporary loans.

SBICs and MESBICs are also placed under an apparent restriction as to the amounts which they may charge for their financings: "Subject to lower rates prescribed by local law, the maximum annual cost for financing shall not exceed fifteen percent of the average amount outstanding." Excluding certain fees for management and "closing" services rendered, the cost of a financing includes "all interest, discount and all fees, commissions and similar charges imposed, directly or indirectly, by the Licensee on the small concern . . ." (13 C.F.R. § 107.301(c)).

Without written SBA approval, a regular SBIC cannot invest more than 20% of its private paid-in capital in any one small business, the comparable percentage for a MESBIC is 30% (13 C.F.R. § 107.301(d); see also Section 306(a) of the Small Business Investment Act).

The statutory language recognizes two generic types of financing equity (§ 304) and long-term loans (§ 305).

As mentioned previously, Section 304 makes it a "function" of the SBIC to provide equity capital financings. In furtherance of this function subsection (b) of Section 304 allows SBIC to employ certain protective measures:

(b) Before any capital is provided to a small business concern under this Section:

(1) the company may require such concern to refinance any or all of its outstanding indebtedness so that the company is the only holder of any evidence of indebtedness of such concern; and

(2) except as provided in regulations issued by the Administration, such concern shall agree that it will not thereafter incur any indebtedness without first securing the approval of the company and giving the company the first opportunity to finance such indebtedness.

Section 305 authorizes SBICs and MESBICs to make loans to small businesses either "directly or in cooperation with other lenders,

incorporated or unincorporated, through agreements to participate on an immediate or deferred basis." Therefore, SBICs and MESBICs may not only lend directly or jointly with another lender but they may also guarantee 100% of a loan made by a lender to a small business. SBICs cannot make loans guaranteed by the SBA even though the Subcommittee has received recommendations for legislative change to permit this type of financing.

Section 305 allows the Administrator to establish a maximum rate of interest which, as discussed previously, is set at 15% by regulation. In addition, Section 305 contains the following restrictions:

(d) Any loan made under this section shall have a maturity not exceeding twenty years.

(e) Any loan made under this section shall be of such sound value, or so secured, as reasonably to assure repayment.

(f) Any company which has made a loan to a small-business concern under this section is authorized to extend the maturity of or renew such loan for additional periods, not exceeding ten years, if the company finds that such extension or renewal will aid in the orderly liquidation of such loan.

Unfortunately, the statute does not define the term "equity" nor financing it refers to as "substantially similar to equity financing" as found in § 303(b), dealing with leverage. However, the SBA, by regulation has defined these terms:

13 C.F.R. § 107.302:

(a) \*\*\*.

(b) "Equity Securities" means:

(1) Stock of any class, or any rights to purchase such stock in a small concern or its affiliate(s) \*\*\*

(2) Limited partnership interests, shares in a syndicate, business trust, joint stock company or association, mutual corporation, cooperative or other joint ventures for profit;

(3) Debt instruments which provide either or both of the following:

(i) A right to convert all or any portion of the debt into securities listed in paragraphs (b) (1) and (2) hereof, or

(ii) A right to acquire the securities listed in

paragraphs (b) (1) and (2) hereof.

As interpreted by SBA, therefore, a convertible debenture is an equity security even if the conversion is never exercised. Similarly a note with an option or warrant attached is also an equity security even if the holder never chooses to take an ownership interest. In effect, when SBA refers to debt it is addressing straight loan situations only. Therefore, Section 304 of the Act is applicable to situations where equity securities *as defined by SBA* are received in return for a financing and Section 305 pertains only to straight loan situations.

The Subcommittee notes that SBA's definition of equity securities is unique. But even with this rather broad interpretation it is to be noted that during the most recent year for which data is available,

SBICs and MESBICs have demonstrated a definite propensity for straight debt financing.

## EXHIBIT XII

## TYPES OF FINANCING PROVIDED TO SMALL BUSINESSES BY SBIC'S AND MESBIC'S

[In percent]

	Calendar 1975		Total outstanding as of Mar. 31, 1975	
	Debt <sup>1</sup>	Equity type <sup>1</sup>	Debt <sup>1</sup>	Equity type <sup>1</sup>
Regular SBIC's:				
Percent of business financing.....	68	32	49	51
Percent of dollars.....	52	48	23	77
Sec. 301(d) SBIC's:				
Percent of business financing.....	72	28	67	33
Percent of dollars.....	61	39	40	60

<sup>1</sup> Definitions: Debt—where a loan only was involved with no equity feature. Equity type—Where there was a pure equity investment, or a combination of debt with equity.

On the basis of reports filed by 259 regular SBICs and 47 MESBICs compiled in the February 1976 *SBIC Digest*, certain operating characteristics become most apparent.<sup>9</sup>

For regular SBICs the average size of an outstanding financing was \$104,000. The average loan financing was \$56,000, the average debt with equity features was \$107,000 and a pure equity investment averaged \$63,000. The comparative statistics for MESBICs were substantially smaller. In this category the average outstanding financing was \$30,000; loans averaged \$16,000; debt with equity features, \$41,000 and pure equity investments only \$16,000.

On the basis of the following two exhibits it can be determined that approximately 55% of the number of businesses financed by regular SBICs have received financing of \$50,000 or less while the comparable figure for MESBICs is about 79%.

## EXHIBIT XIII

## SIZE DISTRIBUTION OF FINANCING OUTSTANDING PER BUSINESS, REGULAR SBIC'S

Size classification	Number of businesses	Percent of number	Dollar amount at cost	Percent of dollars
Under \$25,000.....	2,012	36.4	\$21,227,367	3.7
\$25,000 to \$50,000.....	1,039	18.8	36,967,614	6.4
\$50,000 to \$100,000.....	942	17.0	64,829,121	11.3
\$100,000 to \$250,000.....	969	17.5	148,080,753	25.8
\$250,000 to \$500,000.....	382	6.9	1,9,810,022	22.6
\$500,000 to \$750,000.....	109	2.0	62,522,184	10.9
\$750,000 to \$1,000,000.....	31	.6	26,582,497	4.6
\$1,000,000 and over.....	49	.9	84,921,053	14.8
Total.....	5,533	<sup>1</sup> 100.0	574,940,611	<sup>1</sup> 100.0

<sup>1</sup> Detail may not add to totals due to rounding.

<sup>9</sup> The time period covered by the Digest is not uniform for all reporting SBICs and MESBICs. SBA explains: "Since SBICs do not file their reports with SBA as of a similar date, the data included herein covers as of dates beginning April 1, 1974, and ending March 31, 1975. The majority of reports were as of March 31, 1975."

## EXHIBIT XIV

 SIZE DISTRIBUTION, FINANCING OUTSTANDING PER BUSINESS,  
 MESBIC'S (SEC. 301(d) SBIC'S)

Size classification	Number of businesses	Percent of number	Dollar amount at cost	Percent of dollars
Under \$25,000.....	386	61.2	\$3,829,957	20.4
\$25,000 to \$50,000.....	114	18.1	4,100,183	21.8
\$50,000 to \$100,000.....	97	15.4	6,158,380	32.8
\$100,000 to \$250,000.....	33	5.2	4,393,554	23.4
\$250,000 to \$500,000.....	1	.2	300,000	1.6
\$500,000 to \$750,000.....	0	0	0	0
\$750,000 to \$1,000,000.....	0	0	0	0
\$1,000,000 and over.....	0	0	0	0
Total.....	631	100.0	18,782,074	100.0

<sup>1</sup> Detail may not add to totals due to rounding.

During the period covered by the February 1976 *SBIC Digest* SBA determined that, in the case of regular SBICs, loan financings outstanding had an average nominal interest rate of 11.26% and a median of 11.74%. Debt with equity features had an average rate of 10.31% and a median of 10.15%. During this same period, for MESBIC financings, the interest rate on the average loan outstanding was 9.4% and for debt with equity features, 9.3%. Statistical evidence suggests that the interest rate for straight debt financings is invariably higher than for financings where debt with equity features is involved. It should also be noted that the term of a financing will also vary dependent upon whether or not some future equity rights are reserved. During calendar year 1975 the estimated average term of a straight loan was between five to seven years, whereas the estimated average term of debt with equity was between seven and ten years.

It is evident from the foregoing that SBICs and MESBICs are not making pure equity capital available to small businesses as envisaged by the framers of the Small Business Investment Act. There is an increasing propensity for debt financing coupled with the preservation of some future equity right to be exercised in the event of corporate growth and prosperity.

FNCB Capital Corporation advised the Subcommittee of the hazards of an economy too heavily dependent on debt financing:

One of the major problems in American business today is that we are becoming a debt economy. Several studies have shown that debt as a percentage of total corporate capitalization has risen dramatically over the past ten years. Common stock is permanent capital which does not have to be repaid and on which dividends are paid only at the discretion of the company's board of directors. Debt is temporary capital which must ultimately be repaid and which carries a contractual obligation to make fixed interest payments. Companies never go into bankruptcy because they sell too much common stock but often do so when they sell too much debt.<sup>10</sup>

<sup>10</sup> The Subcommittee realizes, however, that a badly planned or premature public offering of stock may ultimately result in a disastrous situation for the offering company. Raising capital through stock offerings is a highly specialized field marked with a myriad of dangers. The unsuspecting and financially unsophisticated business which braves this area without the benefit of expert assistance may well regret the day it did so.



Dr. Knight advised the Subcommittee that there is, in fact, a relationship between a business' success and its capital structure: "The greater the debt to equity ratio the higher the failure rate." While debt is an integral part of business financing, a business may, in fact, substantially increase its potential for failure if overly committed to debt. However, given the present demand for capital, if debt is the only form of capital *readily* available, it will be absorbed. In addition, there is little doubt that it will also be sought after by those companies which perceive a present demand for capital even though, by assuming this additional debt, they may ultimately reduce their chances for long-term success.

The evidence received during the hearing did not present any indication that SBICs and/or MESBICs will change their present investment policies. On the contrary, the Subcommittee was told by NASBIC that "it is safe to say new entrants into the program will be much more debt oriented." Most of the witnesses, including SBA, attributed the lack of equity financing to a structural deficiency in the statute. The SBA Administrator commented:

Over the past several years the trend has been away from risk taking and financing start-up situations. The SBICs have found it necessary to provide more secured financing in the form of loans and debt securities. For the SBIC industry, since it is so highly leveraged, there must be enough cash flow to service Government debt every 6 months. Since PL 94-305 increases the leverage to SBICs, the problem of cash flow becomes even more acute because of the heavier debt service requirement to the government.

The costs of leveraged funds to SBICs and MESBICs was consistently cited as a factor inhibiting the ability of such firms to make equity investments. Debentures purchased or guaranteed by SBA have interest payments due at six month intervals. Leveraged SBICs and MESBICs must have, we are told, sufficient cash flow to service this debt and meet operating expenses. Pure equity investments, the Subcommittee was advised, do not produce a steady source of income sufficient to meet these needs.

NASBIC, testifying on behalf of its membership, asserted:

\* \* \* matter of deep concern to our industry is the fact that the present design of the SBIC program makes it almost imperative for those companies utilizing leverage to disburse their funds in the form of loans, rather than as pure equity.

FNCB Capital Corporation concurred fully on this issue:

The current structure of the SBIC program does not provide incentives to SBICs to be purchasers of common stock. Quite the opposite, it both forces and encourages the more highly leveraged SBICs to purchase only debt securities. Any SBIC that leverages with SBA debt is currently having to pay 8% for its leverage and must pass this cost, plus the SBIC's operating cost, on to the investee company in the form of either interest or dividends in order to generate a current profit from operations.

As stated previously, FNCB is an equity oriented investor. The Subcommittee, therefore, inquired as to its ability to make equity its predominant mode of investment. A review of FNCB's capital structure reveals the apparent reason. FNCB has a total capitalization, as of June 1976, of \$39.5 million. Only \$2.5 million of this amount is SBA guaranteed debt (leverage). The remaining \$37 million represents capital infusions received from Citicorp, FNCB's parent corporation and sole stockholder. With relatively small debt service and a "patient" parent, FNCB does not require a cash flow comparable to most SBICs or MESBICs. The President of FNCB, Russell Carson, stated:

Our operation is different from the typical SBIC in that we invest large sums of money in companies with major potential, take relatively little current income out of investee companies and adopt a long run perspective on realization of profits. Our capital structure, which contains virtually no debt, is a major factor in our ability to approach the business in this way. In the long run we feel that our policies will significantly benefit Citicorp's shareholders, the companies in which we invest, the federal government and the national economy.

There are some SBIC's, while presumably a very small number, which can obtain needed financing from other than the SBA. Pennsylvania Growth is one such SBIC and, in fact, prefers to secure private financing because of the availability of prepayment features which SBA disallows on those debentures it guarantees or purchases. Mr. William H. Tritsch, Executive Vice President and Director of Pennsylvania Growth, testified:

The leverage available to SBIC's of our size is unattractive especially if we are to be equity oriented. We can provide our own bank leverage at rates near prime with prepayment privileges. This is preferred to SBA funds at just slightly lower rates but (with) no provisions for early prepayment.

However, Pennsylvania Growth indicated that its cost of money from the private marketplace also prohibited it from making pure equity investments despite prepayment privileges: "There is no way that we can provide equity capital—strict equity capital—to a small business and at the same time have to pay the cost of money."

Many of the witnesses urged the Subcommittee to support legislative changes which would decrease the cost of leverage. Some witnesses urged that SBA financings to regular SBICs be in the form of preferred stock. The MESBICs proposed that they be permitted to sell twice as much preferred stock to SBA as is presently permitted under the statute and one MESBIC "hoped that future legislation will provide for unlimited leverage. . . ."

Aside from the cost of money the Subcommittee was offered an additional reason for the paucity of pure equity investments. In order for the investor to realize a capital gain from an equity investment it is axiomatic that, in addition to appreciation, the stock held must eventually prove salable. That is, illiquidity will relegate income to a function of dividends only. The SBA Administrator explained the difficulty:

In discussing the liquidity problem for SBICs, we get into an essential point regarding profitability and cash flow for these venture capital operations. There are times when a portfolio company is "locked-in" and cannot be sold either because it is restricted due to federal regulatory limitations, or because there are no purchasers willing to buy at the current fair value.

Thus, because of regulatory features and economic climates, profits cannot be taken and cash cannot be obtained for reinvestment or distribution to shareholders, on a timely basis.

Dr. Knight and his associate, Mr. Dorsey, stated that there is no "liquidity mechanisms to speak of" and, therefore, equity investments in small business are "highly illiquid and unmarketable."

In order to combat the problem of illiquidity SBICs may take stock with "mandatory buy-back" provisions. The small business, thereby, is required to purchase back its stock at some future time and price as specified in a repurchase agreement. Of course, in certain situations the exercise of "repurchase rights" may have deleterious effects on the small business by, for example, impairing its operating capital or forcing it to secure debt to execute the transaction. In addition, the SBIC or MESBIC may, as stated by SBA, "(sell) such investments to some large business which can integrate the small concern into its operations." The Subcommittee notes, with deep concern, that impairing the financial stability of a small business through a "mandatory buy-back" or facilitating the acquisition of a small business by a large concern is completely contrary to both the letter and spirit of both the Small Business Act and the Small Business Investment Act.

Some SBICs and MESBICs were highly critical of Rule 144 promulgated by the Securities and Exchange Commission. Indeed, this Rule, which affected the sale of restricted securities, was proffered as a reason for the illiquidity of small business stock and, thereby, a disincentive for SBICs and MESBICs to make pure equity investments. NASBIC explained: "Rule 144 is the rule under which we are able to dispose of any stock that we might have in a small business concern. We feel it is much too restrictive, and precludes really an exiting in situations so that we could have a reasonable return and role over the funds into new investments."

SEC gave notice of Rule 144 on January 11, 1972, in its Release No. 5223. The Rule, which became effective on and after April 15, 1972, is summarized by the SEC as follows:

In brief, the rule provides that any affiliate or other person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer, is not deemed to be engaged in a distribution of the securities, and therefore is not an underwriter as defined in Section 2(11) of the Act, if the securities are sold in accordance with all the terms and conditions of the rule. The rule requires, among other things, that the restricted securities must have been beneficially owned for a period of at least two years by the person for whose account they are sold; that the amount sold shall not exceed one percent of the class outstanding, or if

traded on an exchange, the lesser of that amount or the average weekly volume on all such exchanges during the four weeks preceding the sale; and that the securities must be sold in brokers' transactions. In addition, there must be adequate information available to the public in regard to the issuer of the securities and notice of the sale (Form 144) must be filed with the Commission concurrently with the sale.

Some SBICs and MESBICs also claimed that the present tax structure favors debt investments over equity. FNCB Capital Corporation stated: "... the IRS allows SBICs to write losses on debt securities off against current income while losses on common stock must be offset against capital gains thus providing a tax incentive to SBICs to only purchase debt." FNCB suggested, among other things, "tax incentives to SBICs which make common stock investments."

Pennsylvania Growth Investment Corporation shared FNCB's concern on this issue:

The most serious shortcoming of the program is simply that the individual SBIC investor has no incentive to participate as an SBIC shareholder. If his only gain is to come from profits that have been taxed at the portfolio level, the SBIC level, and the investor level, he can do better many other places. In this case it makes sense to allow capital gain treatment of his gains via the passing through by the SBIC of warrants and/or other non-cash dividends.

NASBIC urged a modification of Rule 144 to assist SBICs in their disposal of small business stock: "A very strong liberalization of that (Rule 144) would be a very important factor in assisting us."

Dr. Knight suggested a mechanism whereby MESBICs could possibly liquidate their equity investments. This mechanism, however, is also applicable to regular SBICs:

One possible vehicle for liquidating equity investments of *MESBICs* is the Employee Stock Option Trust (ESOT) whereby a firm uses tax-deductible funds to purchase its own equity for employees; the amount of funds which become tax-deductible for investment in an ESOT is a function of the firm's payroll level; the more labor-intensive the firm, the greater potential for contributions to an ESOT.

As a variation of this theme, Mr. Vincent Ryan, President of Schooner Capital Corporation, suggested that Congress should enact law which would "allow small businesses to have a deduction or be able to borrow funds to repurchase their shares from the investors providing the shares accrue to the benefit of the employees."

Some of the witnesses who appeared before the Subcommittee, or who offered written testimony for its consideration, were deeply concerned with the general lack of venture capital available to small business in start-up situations. SBICs and MESBICs generally invest in ongoing businesses. In fact, of the 40,000 businesses thus far financed by SBICs and MESBICs, SBA estimates that only 10,000 or 25% have been start-up situations.<sup>11</sup> Dr. Komives commented: "If there is

<sup>11</sup> It must be stressed that 25% is an approximation over the life of the program. No figures have been received to indicate the frequency of financings to start-ups in recent years. The Subcommittee assumes, however, the number has significantly decreased over recent years because of generally depressed economic conditions.



a single criticism, it would be aimed at the generalized lack of SBIC involvement with new business start-ups."

Mr. John O. Flender, Treasurer of M.I.T. Development Foundation, specifically addressed the problem of equity availability to new high technology businesses. Mr. Flender stated that during 1950's and 1960's, the new technology-based company had little difficulty in becoming established, but that this situation dramatically changed in the 1970's because of a general decline in the stock market and the disappearance of a public market for new issues. He said, "... new public offerings of small companies declined from 649 in 1969 to one in the first half of 1975. The small technical companies included in the above group fared as poorly. There were no new public offerings in the first half of 1975 compared with 204 in 1967."

Mr. Flender explained the significance of this situation by highlighting the impact which new high technology companies have on the economy: "The potential for creating new jobs in the United States and for making exportable goods to improve our balance of payments is probably greater in new high technology companies than in any other sector of our economy." Mr. Flender referred to a study which he conducted on venture capital and which resulted in a paper written for the Department of Commerce.<sup>12</sup> He advised the Subcommittee that:

The information in that report, which by the way was not intended to be a statistical study, showed that five young, high-technology companies with sales of less than \$1 billion in 1974, created more jobs in the preceding five-year period than six mature companies with combined sales of almost \$37 billion. This second group of companies included: Bethlehem Steel, Dupont, General Electric, General Foods, International Paper and Procter & Gamble. The study also compared the rate at which jobs were created by a group of five seasoned, but innovative, technical companies including Polaroid, 3M, IBM, Xerox, and Texas Instruments. Employment in these five companies increased by 106,600 jobs in the five-year period 1969-1974 as compared with an increase of only 25,600 jobs in the six more mature companies during the same period.

FNCB Capital Corporation also acknowledged the importance of small technological firms and stated that, "To the extent that we are financing smaller, technologically oriented business . . . we are having a significant impact on the total economy in the United States."

Mr. Flender commented upon SBICs as being "relatively inactive" in this area and cited the following reasons:

Unfortunately the capital structure of SBICs is not ideally suited to making investments in startup situations given the current financial environment. The startup, having no income, is unable to service its debt, and the SBICs with relatively high incremental money cost and an operating overhead must, as a practical matter, make investments which include some portion of debt. The operating deficit brought about by this

<sup>12</sup> *The Role of New Technological Enterprises in the U.S. Economy*, U.S. Commerce Department, 1976.

situation can only be covered by realizing gains on portfolio investments. During the first half of the 1970's there were few gains to be realized and the absence of liquidity occasioned both by securities regulations and by unfavorable market conditions meant that even those SBICs who wanted to sell securities were hard pressed to do so at what they thought were reasonable prices.

The higher risk of startups, their inability to pay interest on debt, the greater time required for an investment to reach maturity, unfavorable market conditions, and the uncertainties regarding liquidity have all contributed to SBICs avoiding startups in favor of more seasoned opportunities.

While Mr. Flender was emphatic that start-up businesses cannot service debt and, therefore, are wholly dependent upon equity financing, the Subcommittee received what appears to be contradictory statements from Space Ventures, Inc., a MESBIC wholly owned by Rockwell International:

We prefer debt financing in new startup situations with some future stock convertibility feature. The debt instrument generally requires more business discipline, and this is particularly important during the early life of a new business. Our loan investments can be subordinated to bank loans. The bank will view the subordinated loan as though it was in fact equity capital. This enables the minority businessman to gain leverage from the use of our funds in obtaining additional bank loans.

Space Ventures did not explain how a new start-up business, so financed, could have a sufficient cash flow to service its debt to Space Ventures nor the additional "leverage" debt received through a bank.

The Subcommittee did receive some recommendations geared to provide more equity capital to start-up situations. Mr. Flender suggested, among other things, that SBIC's have access to a source of nondebt capital from the SBA through the sale of preferred stock. He also recommended tax and SEC regulatory reform. Dr. Komives observed: "Clearly the United States needs a tax policy that greatly favors gains and losses in the new business equity investment game. Then we would see many more new firms starting and perhaps greater competition in the American Economy." Dr. Komives cautioned, however:

It is conceivable that the SBIC program could be subsidized or urged to make more new business investments. But to urge that this be done under the present conditions of leverage and taxation seems to me hopeless and I would not urge Congress to do so at this time without a broader look at how indeed new businesses get started and eventually funded and the subsequent rewards or losses that occur. Currently there is nobody, in any political party or in any University with the knowledge or background who could easily undertake such a study. It would need to be a lengthy and detailed study by careful scientists (not administrators) and would take over two years to complete in a satisfactory manner. Yet I urge Congress to

undertake the funding of such a study. By the way, this ought to be a study conducted by the National Science Foundation in collaboration with a well qualified University, such as the University of Texas, and not be a study conducted by any Federal Government agency. Based upon that work, Congress might then undertake to review the fabric of the American Economy and make suitable enactments to spur new ventures and capitalism in its truest sense.

### *SBIC and MESBIC Industry Characteristics*

The evidence received did present the Subcommittee with certain information regarding the characteristics of the SBIC and MESBIC industry—an industry which has now exceeded the One Billion Dollar level.

The evidence established that the size of an SBIC or MESBIC, measured in terms of capitalization, is positively correlated with its potential for success, as well as the number, size and type of financings it provides to small businesses. Further, the success of a small business is a function of the amount and type of financing it receives.

Data supplied by the SBA established that most SBIC's issued licenses prior to 1966 has a relatively small capitalization:

EXHIBIT XV  
OUTSTANDING SBIC LICENSES AS OF MAR. 31, 1966, BY CAPITAL SIZE

	\$300,000 or less	\$300,001 to \$1,000,000	\$1,000,001 to \$5,000,000	\$500,000,001 and over	Total
Number of licensees.....	290	203	35	14	542
Percent of licensees.....	53.5	37.5	6.4	2.6	100

Subsequent to this period SBICs have demonstrated a trend towards higher capitalization.

EXHIBIT XVI  
REGULAR SBIC'S<sup>1</sup> PRIVATE CAPITALIZATION AT TIME OF LICENSE

Calendar year	\$300,000 or less	\$300,001 to \$1,000,000	\$1,000,001 to \$5,000,000	\$5,000,001 and over	Total
1975.....	5	9	2	0	16
1974.....	3	9	3	1	16
1973.....	5	3	1	0	9
1972.....	2	6	0	0	8
1971.....	4	2	0	0	6
1970.....	2	2	2	0	6
1969.....	1	5	2	0	8
1968.....	0	4	2	1	7
1967.....	1	8	1	1	11
1966.....	0	7	1	0	8
1965.....	2	5	1	0	8
Total 65 thru 1975.....	25	60	15	3	103
Percent.....	24.3	58.3	14.5	2.9	100.0

<sup>1</sup> The size of the SBIC at the time of licensing is not available for licenses issued prior to 1965.

SBA recently completed a review of the SBIC history "in an effort to determine the survival rates of SBICs licensed in the respective program years." The data collected from that study is represented in the following exhibit.

EXHIBIT XVII  
SBIC SURVIVAL RATES

Calendar year—	SBIC's licensed	Operating (December 1974) as percent of licensed	Nonoperating (December 1974) as percent of licensed	Age at time of surrender (years)
1959	61	47.5	52.5	7.5
1960	113	32.7	67.3	7.3
1961	227	28.5	71.5	6.6
1962	219	23.3	76.7	5.8
1963	65	29.2	70.8	5.2
1964	49	34.7	65.3	4.5
1965	8	37.5	62.5	3.3
1966	8	50.0	50.0	1.8
1967	11	63.6	36.4	3.2
1968	8	62.5	37.5	3.3
1969	10	80.0	20.0	2.6
1970	25	92.0	8.0	2.0
1971	28	89.3	10.7	1.2
1972	22	100.0	0	0
1973	22	86.4	13.6	1.1
1974	26	100.0	0	0

On the basis of the above SBA has reached a number of important conclusions:

As indicated in the above table, the lowest survival rate was for the SBICs licensed in 1959, 1960, 1961, 1962, and 1963.\* In those 5 years, 735 SBICs were licensed and at the end of 1974 only 215 or 29.2% were still operating. The average age for the SBICs of this group that surrendered was 6.5 years at the time of surrender. Of all the funds charged off by SBA in the history of the SBIC program, 94% was applicable to the SBICs licensed in this 5-year period.

During the next 5 years, 1964 through 1968, only 84 SBICs were licensed. Of this group, 36 or 42.8% were still operating at the end of 1974. For the SBICs that surrendered from this group, the average age at the time of surrender was only 3.2 years.

Since the SBICs which were licensed from 1969 through 1974 cannot as yet be considered "seasoned", not much can be said about their survival rates.

Since the vast majority of licensees entering the program prior to 1965 were in the smallest size categories and since the survival rates are lowest for those years, it can be assumed that the survival rate is lowest for the smaller SBICs.

In summary, over the entire period from 1959 through 1974, the survival rate for SBICs was 40% with the lowest rate, 23%, applicable to SBICs licensed in 1962.

The MESBIC program is relatively new and therefore SBA cannot obtain detailed empirical data comparable to that presented above for this program. However, if the SBIC experience can be validly used as a measure, certain assumptions can be made. The following exhibit presents the capitalization size of MESBICs at the time of license:

\*The Subcommittee notes that the survival rates for 1964 and 1965 are lower than the survival rate for 1959. However, the validity of SBA's analysis is not substantially affected by this error.



## EXHIBIT XVIII

## MESBIC'S (SEC. 301(d) SBIC'S) CAPITALIZATION SIZE AT TIME OF LICENSE

Calendar year	\$300,000 or less	\$300,001 to \$1,000,000	\$1,000,001 to \$5,000,000	\$5,000,001 and over	Total <sup>13</sup>
1975	2	11	0	0	13
1974	5	4	1	0	10
1973	8	5	0	0	13
1972	8	5	1	0	14
1971	15	7	0	0	22
1970	18	1	0	0	19
1969	2	0	0	0	2
1968	0	1	0	0	1
Total, 1968-75	58	37	2	0	94
Percent	61.7	36.2	2.1	0	100

Dr. Knight conducted a study based upon the number and size distribution of licensed SBICs in 1972 and MESBICs in 1975 and the returns on investment experienced by SBICs and in MESBICs in each size category over time. His conclusions are as follows:

1. In 1975, MESBICs were concentrated almost exclusively in two smaller size groups, with only five firms in the third size group.

2. Between 1968 and 1972 the proportions of SBICs in the larger size categories were growing while the proportions in the two smaller categories were decreasing.

3. Between 1968 and 1972 larger SBICs experienced greater returns on investments than smaller ones.

4. The MESBIC program as a whole has continued to be unprofitable; however, profitability seems to have improved very slightly, probably because the average size of MESBICs has been increasing.

5. It is therefore apparent that in 1975 most individual MESBICs were too small to realize adequate returns on investment to ensure long-term profitability and survival.

From the foregoing it is obvious that the success of an SBIC or MESBIC is a function of its capitalization.

There is also a relationship between the size of an SBIC or MESBIC and the number and dollar amount of outstanding financings. According to data received during the period covered by the February 1976 *SBIC Digest*, SBA has concluded that: "Fifty-five percent of these outstandings (i.e. dollar amounts of financing outstanding to small business) are concentrated in the portfolios of the 26 largest SBICs which represent 10% of the number of reporting SBICs. The group of smallest SBICs which represent 37.8% of the number of reporting SBICs held only 5.6% of the outstanding dollar balances."<sup>13</sup> The following exhibit demonstrates the distribution of outstanding balances for regular SBICs.

<sup>13</sup> SBA's *Digest* does not contain financing information relative to MESBICs by the size of the MESBIC. However, the Subcommittee will assume that findings relative to an SBIC's size are also valid for MESBICs.

EXHIBIT XIX  
REGULAR SBIC, PORTFOLIO OUTSTANDING BALANCES<sup>1</sup>

SBIC asset size	Number of SBIC's	Percent of SBIC's	Number of businesses in portfolio	Percent of businesses	Dollar amount at cost	Percent of dollars
0 to \$1,000,000.....	98	37.8	1,161	21.0	\$32,209,260	5.6
\$1,000,000 to \$2,000,000.....	63	24.3	1,035	18.7	47,569,278	8.3
\$2,000,000 to \$5,000,000.....	50	19.3	1,133	20.5	90,525,111	15.8
\$5,000,000 to \$10,000,000.....	22	8.5	725	13.1	89,176,776	15.5
Over \$10,000,000.....	26	10.0	1,479	26.7	315,460,186	54.8
Total.....	259	100.0	5,533	100.0	574,940,611	100.0

<sup>1</sup> See footnote 9 supra, p. 24 for applicable period.

<sup>2</sup> Detail may not add to totals due to rounding.

The data also demonstrates a definite relationship between the size of an SBIC and the average amount of its investments per small business.

EXHIBIT XX  
SIZE OF INVESTMENT PER SMALL BUSINESS BY SBIC SIZE CATEGORY<sup>1</sup>

Size group	Average	Median
Up to \$1,000,000.....	\$27,743	\$22,676
\$1,000,000 to \$2,000,000.....	45,961	34,105
\$2,000,000 to \$5,000,000.....	79,899	46,906
\$5,000,000 to \$10,000,000.....	123,002	88,556
Over \$10,000,000.....	212,867	92,597
All sizes.....	103,797	43,154

<sup>1</sup> See footnote 9, supra, p. 24 for applicable period.

The following exhibit shows further that the larger SBICs have a greater propensity for equity type financings than do their smaller counterparts.

EXHIBIT XXI  
FINANCING TYPE BY SBIC SIZE<sup>1</sup>  
[Percents based on number of businesses; dollar amounts in millions]

Financing type	SBIC size—					All sizes
	Up to \$1	\$1 to \$2	\$2 to \$5	\$5 to \$10	Over \$10.0	
Loans.....	66	53	46	38	42	49
Equity type.....	34	47	54	62	58	51
Total.....	100	100	100	100	100	100

<sup>1</sup> See footnote 9, supra, p. 24 for applicable period.

As mentioned previously the Subcommittee did receive evidence which indicated that a small business' success is, in some part, related to the type of financing it received—the higher proportion of its capitalization represented by debt, the higher its probability of failure. But, in addition, some witnesses also indicated a positive relationship between the *size* of an investment and the investee's success. Studies were cited to support this latter conclusion and the Subcommittee is not in receipt of any contradictory data.

The high correlation between the size of capitalization and program success is incontrovertible. The witnesses agreed, as stated by Pennsylvania Growth Investment Co., that it is "impractical to operate at a very minimum capitalization." NASBIC, and others, suggested that the minimum amount of private paid-in capital should be raised from the present \$150,000 to \$500,000 for both regular SBICs and MESBICs. The American Association of MESBICs suggested that the minimum private paid-in capital for future MESBICs should be set at \$1 million. Dr. Knight emphatically stated that not only is the size of the total MESBIC program too small but the size of the individual MESBICs are too small "to finance firms with high probabilities of success." In fact, the Subcommittee was told that "One \$1,000,000 MESBIC will probably have as much impact as ten to fifteen minimum-size MESBICs in promoting minority owned businesses." Dr. Knight recommended, among other thing, that:

Individual MESBICs and the entire MESBIC program should be substantially increased. At a minimum, a private capitalization of \$100 million should be set as a target for the MESBIC program in 1976. Moreover, the development of five to ten very large (\$10-20 million total capital) MESBICs is recommended in order to permit the finance of large, rapid growth, high technology ventures as proposed earlier.

No recommendations were received as to how the SBA would accomplish this task.

In its evaluation of the SBIC and MESBIC program the Subcommittee is mindful that there are special considerations inherent to the operation of MESBICs. This is so because MESBICs are formed for the specific purpose of financing businesses owned by the economically or socially disadvantaged.

While the program is predicated upon economic considerations, a number of large corporations have considered the MESBIC as an outlet to fulfill perceived social obligations. However, most witnesses agreed that a viable minority business community cannot be based on gratuitous expressions of corporate consciousness but should be based upon a recognition of the legitimate economic needs and business potential of a neglected segment of our society. OMBE stated:

\* \* \* we believe that progress in the minority business field in the long run cannot be built on charity and the social consciousness of major corporations. We do believe that any long-range program must involve viable minority businesses, an opportunity for profit by the lender-investor, and a minimum of governmental intervention.

The witness did indicate that the "social MESBIC" was more common during the earlier days of the program. However, the Subcommittee was informed that, at present, there do exist several MESBICs which are so oriented. OMBE characterized the MESBIC industry thus:

Today we can characterize the MESBIC industry as a multipurpose, multi-faceted financial industry. Some MESBICs have as their goal a socially-oriented, community

service. Profits are secondary to the service to be performed, and regular losses may not only be accepted but may be budgeted.

Another group of MESBICs combined a limited profit motive with social responsibility. These MESBICs tend to have a group of corporate sponsors who may consider their investment as more of a community responsibility than a means of maximizing profit return.

A third group of MESBICs may have overall return on investment as a goal. Companies such as franchisers can view the MESBIC as a means to expand their operations, develop overall profit centers and assist disadvantaged businessmen.

And, finally, a fourth group may simply anticipate a full participation in soundly conceived, soundly operated minority businesses which should earn a normal profit for themselves and return a comfortable profit for the MESBIC.

OMBE estimated that approximately 16 MESBICs fall into the first category, 20 in the second, 20 in the third, and 25 in the last category.

SBA readily admits that—

A few MESBICs that are owned by large corporations are operating under a policy which has prevented the MESBIC from maximizing its profits to the fullest legal extent. These MESBICs are reluctant to charge the maximum interest rate and their operating expenses are subsidized by their parent.

SBA points out, however, that MESBICs should not be established solely for social considerations: "The profit motive must be present along with the social motive."

Those individuals or corporations who benevolently seek the MESBIC program solely to satisfy social needs, we are told, only exacerbate the situation. Gulf South Venture stated:

The tasks of social and economic change are for the tough-minded and competent. Those who come to the tasks with the currently fashionable mixture of passion and incompetence in the hard economics of social change only add to the confusion.

Dr. Knight joined with the other witnesses and stated that a MESBIC should not be viewed as a "social instrument," but as a "profit making vehicle." He further stated that socially oriented MESBICs may lack sound business judgment. Such corporations may view MESBIC "investments" as unretrievable expenses of its perceived social obligation and, as stated by Dr. Knight: "When you put money in and view it as a loss, it is awfully easy for it to become a self-fulfilling prophecy."

Part of the Subcommittee's inquiry was intended to ascertain the full economic benefits accruing to the shareholders of SBICs and MESBICs.



FNCB Capital Corporation advised the Subcommittee that—  
 “\* \* \* the SBIC industry has been at best marginally profitable since it began in 1958.” Schooner Capital was far more demonstrative in its assessment of the SBIC program and stated, “There is no incentive for investments, in fact one is better off to liquidate or become a small loan company. . . . Today there is no economic reason to take a risk when you can buy assets in the market at a discount, and at the same time receive a return on your investment.”

The American Association of MESBICs expressed a similar concern:

The MESBIC industry has not been profitable and will not likely attain even modest levels of profitability in the future under present SBA regulations.

However, the Subcommittee did receive testimony from some SBICs and MESBICs which did acknowledge the realization of a return on investment. For example, Pennsylvania Growth Investment Corporation cited a 10% return on investment over the last five years while Gulf South Venture Capital advised the Subcommittee that its average rate of return is 11%.

In an effort to determine the profitability of the industry the Subcommittee obtained numerous statistical reports from the agency.

SBA has compiled data received from 200 reporting SBICs and 29 reporting MESBICs for the year 1975. The following two exhibits represent what might be considered a profit and loss statement for the reporting companies.

#### EXHIBIT XXII

##### *SBIC's—Statement of operations realized for 12 mo. ended SBIC fiscal year 1975 (based on 200 reporting SBIC's)*

<i>Investment income</i>	
Revenue:	
From portfolio:	
Interest on loans and debt securities .....	31, 943, 100
Dividend income .....	2, 584, 349
Total .....	34, 527, 449
From services provided:	
Management services .....	1, 204, 941
Application and other fees .....	655, 824
Total .....	1, 860, 765
From other sources:	
Interest on invested idle funds .....	12, 475, 057
Income from assets acquired in liquidation of loans and investments (net of \$..... expenses) .....	3, 505, 811
Other income .....	3, 294, 420
Total .....	19, 275, 288
Total revenue .....	55, 663, 502

*SBIC's—Statement of operations realized for 12 mo. ended SBIC fiscal year  
1975 (based on 200 reporting SBIC's)—Continued*

*Investment income—Continued*

**Expenses:**

Financial expenses:	
Interest on long-term debt.....	25,793,847
Commitment fees.....	37,284
Other financial costs.....	287,295
Total financial expenses.....	26,118,426

**Remuneration:**

Officer salaries.....	5,509,702
Employee salaries.....	1,779,937
Employee benefits.....	604,927
Investment advisory and management services.....	1,966,115
Director's and stockholder's meetings.....	464,602

Total remuneration.....	10,325,283
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**Initiating and servicing costs:**

Advertising and promotion.....	290,630
Appraisal and investigation.....	241,025
Communication.....	446,121
Legal fees.....	1,665,122
Travel expense.....	915,572

Total initiating and servicing costs.....	3,558,470
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**Fixed facilities:**

Cost of space occupied.....	1,005,701
Depreciation and amortization expense.....	208,454

Total fixed facilities.....	1,209,155
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**Other costs:**

Audit and examination fees.....	1,199,739
Insurance expense.....	302,776
Taxes expense (excluding income taxes).....	598,937
Provision for losses on receivables.....	1,915,107
Miscellaneous expenses.....	2,195,208

Total other costs.....	6,211,767
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Total expenses.....	47,423,101
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Net investment income before provision for income taxes.....	8,240,401
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(a) Provision for income taxes.....	1,943,393
(b) Less deferred credit (charge) to future taxes.....	(505,860)

Total.....	2,449,253
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Net investment income.....	5,791,148
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**Realized gain (loss) on sale of securities:**

Net sale price.....	27,854,928
Cost of securities sold.....	44,724,667
Net prior to income tax provision.....	(16,869,739)

(a) Provision for income taxes.....	2,569,796
(b) Less deferred credit (charge) to future taxes.....	(322,092)

Total.....	2,891,888
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Realized gain (loss) on sale of securities.....	(13,977,851)
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## EXHIBIT XXIII

MESBIC's—Statement of operations realized for 12 mo. ended SBIC fiscal year 1975 (based on 29 reporting MESBIC's)

## Investment income

## Revenue:

## From portfolio:

Interest on loans and debt securities	754,310
Dividend income	3,750

Total	758,060
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## From services provided:

Management services	81,314
Application and other fees	10,730

Total	92,044
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## From other sources:

Interest on invested idle funds	1,430,394
Income from assets acquired in liquidation of loans and investment (net of \$5 expenses)	4,007
Other income	5,210

Total	1,439,611
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Total revenue	2,289,715
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## Expenses:

## Financial expenses:

Interest on long-term debt	364,480
Commitment fees	0
Other financial costs	2,291

Total financial expenses	366,771
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## Remuneration:

Officers salaries	415,508
Employee salaries	240,769
Employee benefits	26,614
Investment advisory and management services	218,765
Director's and stockholder's meetings	6,591

Total remuneration	908,247
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## Initiating and servicing costs:

Advertising and promotion	2,990
Appraisal and investigation	7,979
Communication	38,590
Legal fees	82,200
Travel expense	68,810

Total initiating and servicing costs	200,569
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## Fixed facilities:

Cost of space occupied	58,708
Depreciation and amortization expense	14,174

Total fixed facilities	72,882
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*MESBIC's—Statement of operations realized for 12 mo. ended SBIC fiscal year 1975 (based on 29 reporting MESBIC's)—Continued*

*Investment income—Continued*

**Expenses—Continued**

**Other costs:**

Audit and examination fees	63,038
Insurance expense	14,219
Taxes expense (excluding income taxes)	44,829
Provision for losses on receivables	120,528
Miscellaneous expenses	264,704

Total other costs 507,318

Total expenses 2,055,787

Net investment income before provision for income taxes 233,928

(a) Provision for income taxes 65,404

(b) Less deferred credit (charge) to future taxes 0

Total 65,404

Net investment income 168,524

**Realized gain (loss) on sale of securities:**

Net sale price 994,034

Cost of securities sold 1,783,316

Net prior to income tax provision (789,282)

(a) Provision for income taxes (193,113)

(b) Less deferred credit (charge) to future taxes 0

Total (193,113)

Realized gain (loss) on sale of securities (596,169)

Upon further analysis of the expenses incurred by SBICs and MESBICs the Subcommittee noted a wide divergence between the two types of investment companies.

**EXHIBIT XXIV**

*Expense analysis based on 200 reporting SBIC's—SBIC fiscal year 1975*

**Expenses:**

**Financial expenses:**

Interest on long-term debt	Percent
Commitment fees	54.4
Other financial costs	.1
	.6

Total financial expenses 55.1

**Remuneration:**

Officer salaries	11.6
Employee salaries	3.7
Employee benefits	1.3
Investment advisory and management services	4.1
Directors' and stockholders' meetings	1.0

Total remuneration 21.7

**Initiating and serving costs:**

Advertising and promotion	.6
Advertising and investigation	.5
Communication	.9
Legal fees	3.5
Travel expense	1.9

Total initiating and servicing costs 7.4



*MESBIC's—Statement of operations realized for 12 mo. ended SBIC fiscal year  
1975 (based on 29 reporting MESBIC's)—Continued*

*Investment income—Continued*

Fixed facilities:

Cost of space occupied.....	2.1
Depreciation and amortization expense.....	.4
Total fixed facilities.....	2.5

Other costs:

Audit and examination fees.....	2.5
Insurance expense.....	.6
Taxes expense (excluding income taxes).....	1.3
Provision for losses on receivables.....	4.0
Miscellaneous expenses.....	4.6

Total other costs..... 13.0

Total expenses..... <sup>1</sup>100.0

<sup>1</sup> Detail may not add to totals due to rounding.

EXHIBIT XXV

*Expense analysis based on 29 reporting MESBIC's—SBIC fiscal year 1975*

Expenses:

Financial expenses:

	Percent
Interest on long-term debt.....	17.7
Commitment fees.....	
Other financial costs.....	.1
Total financial expenses.....	17.8

Remuneration:

Officer salaries.....	20.2
Employee salaries.....	11.7
Employee benefits.....	1.3
Investment advisory and management services.....	10.6
Director's and stockholder's meetings.....	.3
Total remuneration.....	44.1

Initiating and servicing costs:

Advertising and promotion.....	.1
Appraisals and investigation.....	.4
Communication.....	1.9
Legal fees.....	4.0
Travel expense.....	3.3
Total initiating and servicing costs.....	9.7

Fixed facilities:

Cost of space occupied.....	2.8
Depreciation and amortization expense.....	.7
Total fixed facilities.....	3.5

Other costs:

Audit and examination fees.....	3.1
Insurance expense.....	.7
Taxes expense (excluding income taxes).....	2.2
Provision for losses on receivables.....	5.8
Miscellaneous expenses.....	12.9
Total other costs.....	24.7

Total expenses..... <sup>1</sup>100.0

<sup>1</sup> Detail may not add to totals due to rounding.

As is evident by comparing exhibits XXIV and XXV a major disparity in expense between SBICs and MESBICs is the "cost" of their capital. As far as other expenses are concerned SBA has promulgated several regulations which subject some of these expenditures to its scrutiny.

Remuneration for salaries and management services provided to the SBICs and MESBICs do consume a substantial part of expenses for both groups of companies. The average SBIC and MESBIC, according to testimony received by NASBIC, employs four persons. The compensation paid to these persons is initially subject to approval by SBA when it passes upon the request for license. Those SBICs and MESBICs which receive leverage from SBA cannot increase compensation to its employees without first securing SBA's prior written consent, although this provision does not apply to employees receiving annual compensation of \$10,000 or less.<sup>14</sup>

An SBIC or MESBIC may also employ an investment adviser or manager but it must submit to SBA "a copy of the contract for prior written approval." (13 C.F.R. § 107.809.)

Most SBICs and MESBICs have an integral part of their operation devoted to providing management assistance to their financed businesses. The motivation, of course, is to protect their investments. Monthly or even weekly reports to SBICs and MESBICs from their financed businesses are not uncommon. However, SBICs and MESBICs are generally prohibited from assuming control over their investee companies. (13 C.F.R. § 107.901.)

An SBIC or MESBIC may charge a small business for services provided. However, 13 C.F.R. § 107.601(b) provides: "The Licensee shall maintain a record for examination by SBA of the time spent and charges made for such services and such charges shall not exceed comparable charges by established professional non-Licensee consultants."

It should also be noted that the expenses reported by some SBICs or MESBICs may be understated. This is due to the fact that the operations of some SBICs and MESBICs may be subsidized by their parent sole stockholder. The motivation for such activity was not established before the Subcommittee.

In a similar fashion the sources of revenue received by SBICs and MESBICs also demonstrate a divergent pattern of operations.

## EXHIBIT XXVI

REVENUE STATEMENT FOR 12 MONTHS ENDED SBIC FISCAL YEAR 1975 BASED ON 200 REPORTING SBICs,  
29 REPORTING MESBICs

	SBIC		MESBIC	
	Amount	Percent total revenue	Amount	Percent total revenue
Portfolio:				
Interest on loans and debt securities	\$31,943,100	57.4	\$754,310	32.9
Dividend income	2,584,349	4.6	3,750	.2
Services provided:				
Management services	1,204,941	2.2	81,314	3.5
Application and other fees	655,824	1.2	10,730	.5
Other sources:				
Interest on invested idle funds	12,475,057	22.4	1,430,394	62.5
Income from assets acquired in liquidation of loans and investments	3,505,811	6.3	4,007	.2
Other income	3,294,420	5.9	5,210	.2
Total revenue	55,663,502	100.0	2,289,715	100.0

<sup>14</sup> See 13 C.F.R. § 107.203(b) (3) (iii) and 13 C.F.R. § 107.205(b).

The information presented above with respect to the revenue and expense structure for SBICs and MESBICs have raised several areas of deep concern with the Subcommittee. In specific, the Subcommittee inquired into: (1) The method whereby securities held by SBICs or MESBICs are evaluated; (2) the permissibility of SBICs or MESBICs "passing-through" their assets to shareholders; and (3) the amounts and usage of idle funds, i.e., those funds not invested in small businesses.

As stated previously an SBIC or MESBIC may receive, in return for its financing notes, debentures, convertible bonds, warrants, options or stock. If such securities are received in combination form it is clear that an evaluation problem may well exist. That is, what part of the actual value of the financing is attributable to each security received? The situation is especially critical with small business concerns whose securities are not publicly traded and, thereby, not susceptible to a ready determination of market value.

The SBA, we are told, does not evaluate the securities received by SBICs or MESBICs but does set guidelines for the evaluation. Pennsylvania Growth Investment Corporation stated that SBA's activity in this regard is limited to "trying to discover how we evaluate it. They do not try to make their own estimation of what it is worth."

In many situations a warrant or option will carry its own negotiated price. In these types of situations each security received by the SBIC or MESBIC will bear a separate agreed upon value. We are advised that such evaluations will survive challenges from the IRS or SBA if they are deemed to be reasonable.

The Subcommittee is deeply concerned about the apparent possibility of SBICs and MESBICs to pass-through certain of their assets to their shareholders, who in turn sell the assets at an appreciated value which is never reflected on the SBIC or MESBIC income statement. Such a situation could arise, for example, if an SBIC received both a note and a stock option in return for its financing a small business. The option may carry a nominal, albeit, reasonable price at the original time of purchase. If the option is passed through to a shareholder of the SBIC and later exercised when the stock of the company has appreciated the shareholder may realize substantial capital gains through the sale of stock obtained from the exercise of the option. This "gain" is not reflected on the "books" of the SBIC or MESBIC but is, in fact, a true return on investment realized by the individual shareholder who has so benefited.

The evidence did not disclose the methods whereby a "pass-through" may be effected. However, SBA is certain that "pass-throughs" do happen and further that they may occur without the transaction ever being reported to the agency. Moreover, the Subcommittee was advised by SBA that SBICs and MESBICs can, in certain limited situations, actually value some securities at zero on their books.

We were informed by some witnesses, however, that it is unreasonable to suppose that an SBIC or MESBIC would pass through a great deal of its assets to its shareholders because, among other things, the companies do need capital with which to operate. NASBIC testified that SBICs and MESBICs cannot pass through securities on an indefinite basis "because each time you do that you lower the cost (i.e.,

tax) basis that the shareholders have on their own SBIC stock, and you cannot reduce that to zero."

SBA does have a regulation, 13 C.F.R. § 107.1005, which provides in part relevant: "(a) Except with a written exemption from SBA in special instances, a Licensee shall not dispose of assets (including assets in liquidation) to any Associate (which includes shareholders). As a prerequisite to such exemption, the Licensee must demonstrate that the proposed terms of disposal are no less favorable to it than are obtainable elsewhere." Further, Section 310(b) of the Act provides that each SBIC and MESBIC is to be audited at least once a year. But, despite all the regulations and their concomitant reporting requirements as stated above, SBA informed the Subcommittee, "We do not know, based on present reporting systems, the true economic rate of return to SBIC shareholders."

The Subcommittee next explored the question of "idle funds," that is, funds which are available for investment but which have not been invested by the SBIC or MESBIC in small business.

The SBA estimates that, as of March 31, 1975, approximately half of the MESBIC funds available for investment have not been so utilized. Based upon data collected from 200 reporting SBICs, cash and invested idle funds of regular SBICs account for about 27% of their total asset value.<sup>15</sup>

Of course, there is less incentive for regular SBICs to invest idle funds in other than small business investments or to maintain high levels of uninvested cash if such money was obtained through SBA leverage since that leverage presently "costs" about 8%. MESBICs, on the other hand, which receive leverage from SBA incur a *present* cost of only about 3% for such amounts.<sup>16</sup> The incentives, therefore, do vary between the two-types of investment companies.

Dr. Knight testified that there are "three reasons why maintaining a high level of idle funds relative to invested assets is not only appropriate but may actually facilitate the goals of the MESBIC program." The three reasons cited by Dr. Knight are as follows:

First, it is necessary to recognize that the more successful *MESBIC* investee firms are likely to need subsequent infusions of capital from investors. Unless a rapidly growing investee can obtain additional external funds to finance its growth, that growth must necessarily be financed internally and may therefore be limited. Moreover, it is not reasonable to expect that the initial investment by a *MESBIC* in a new firm will anticipate future growth and capital requirements, and will be sufficient to meet them. Adequately forecasting the capital requirements of a new venture is most difficult, especially when the venture is very successful and experiences rapid growth. In addition, conservative investment practice dictates that capital availability for a new firm be limited initially and expanded only as the investee demonstrates a high probability of success, real promise of growth and genuine need for additional growth capital.

Second, it is useful to note that new investment proposals are continuously presenting themselves to *MESBICs*, that

<sup>15</sup> See footnote 9, *supra*, p. 24 for applicable time period.

<sup>16</sup> See Exhibit VII, *supra*, p. 14.



the rate at which they present themselves is erratic and unpredictable, and that those proposals, if sufficiently attractive to be funded, usually require rapid action once the investment decision is made. It is unrealistic to expect that an entrepreneur will have confidence in an investor group which states that although it desires to fund his venture, procurement of funds must be made from another source before he can receive his money. In addition, it must be noted that often an investment decision may be contingent upon coordinating a number of investors into a syndicate, all of whose members are to invest in the venture. The viability of such a syndicate rests upon the ability of its members to furnish capital simultaneously, not at different times. Failure of individual members to furnish capital in a timely fashion can defeat the purposes of a syndicate. It is obvious that the holding of liquid funds by *MESBIC*s is also dictated by their need to react to attractive investment proposals at once rather than having to wait for some time to procure the needed investment capital.

The third reason for holding liquid funds by a venture capital group such as a *MESBIC* derives from the ability of such a policy to lower the overall risk to the fund's stockholders—that is, the overall exposure to loss—but combining less risky assets such as government securities with more risky assets such as venture capital investments.

CEDCO, a Chicago based *MESBIC*, informed the Subcommittee that *MESBIC*s were under "undue pressure to become fully invested" and further commented that this pressure was being applied, "notwithstanding the fact that the failure of a few of the portfolio companies drastically reduces the capital position of the *MESBIC* and leads to capital impairment. Adequate reserves must be maintained to take advantage of sounder investment opportunities as they materialize and/or assist portfolio companies in the face of unforeseen financial problems." However, CEDCO also stated that at the present time there is a "lack of sound investment opportunities." Pennsylvania Growth and Investment Company, an *SBIC*, also concurred and commented that there is a "general slow down of valid applicants in our area." SBA reports that some *MESBIC*s have, in fact, indicated "difficulty in locating viable investment opportunities."

Dr. Knight indicated that the level of idle funds is also a function of time: "I would not feel uncomfortable with a *MESBIC* or *SBIC* . . . in the first year keeping as much as 80 percent idle. I would think for a stable organization, let's say, 10 years or so, that it probably is not unreasonable for them to keep as much as 30% in idle funds." Mr. Dorsey, Dr. Knight's associate, indicated that conservative investment policies may bring this figure even higher.

Walter W. Durham, President of *MESBIC* Financial Corporation of Dallas, advised the Subcommittee, "By the time a *MESBIC* has become five or six years old, it should have a substantial amount of its money out, and it should be showing some success. If it doesn't, the shareholders should change the management. But it should be the shareholders' decision first." However, Mr. Durham did state that *MESBIC* Financial Corporation of Dallas, which was formed in 1970,

maintains a reserve of between 30% to 40% of its capital for new investment opportunities.

OMBE also agreed that idle funds are essential for venture capitalists: "Between 30 and 50 percent of private capital in a venture capital company should remain liquid to take care of secondary funding and . . . new opportunities."

The investment of idle funds is restricted by Section 308(b) of the Act. According to that provision SBICs and MESBICs "may invest funds not reasonably needed for their current operations in direct obligations of, or obligations guaranteed as to principal and interest by, the United States, or in insured savings accounts (up to the amount of the insurance) in any institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation." Applicable regulations allow idle funds to be invested in Time Certificates of Deposit which mature within a year or less.<sup>17</sup> Certificates of Deposit (CDs) apparently are the predominate mode for investing the MESBICs' idle funds. CEDCO testified that between the middle of 1974 through 1975 it was receiving "9.5 or 10 percent" on its CDs but that the interest rate has now dropped to its present level of 5 1/4%.

SBA does have a regulation which deals with the "inactivity" of its licensees. Title 13 C.F.R. § 107.1003 provides:

(a) The Act contemplates that a Licensee shall conduct active operations to meet the needs of small concerns. Accordingly, inactivity constitutes a violation of these regulations.

(b) A Licensee which on the close of any full fiscal year has more than twenty-five percent of its assets in idle funds . . . shall be presumed inactive if it has not, during the past eighteen months, provided Financing aggregating at least twenty-five percent of the average amount of its said idle funds during the fiscal year within such eighteen-month period. It shall promptly file written reasons for its inactivity.

The Subcommittee was advised that a high level of idle funds does not necessarily indicate "inactivity." Idle funds are, we are told, a function of (1) the cost of money; (2) other operating and overhead expenses; (3) the time period during which the SBIC or MESBIC has been in existence or has received leverage; (4) the amount of financings outstanding and the perceived need for possible secondary rounds of financing; (5) reserves for new investment opportunities; and (6) the peculiar investment policy of each individual SBIC or MESBIC. Dr. Knight cautioned that actions taken merely for the purpose of prohibiting the retention of idle funds may prove injurious to program objectives:

We therefore conclude that any measure to discourage MESBICs from holding liquid funds will tend (1) to place unreasonable return requirements on the funds managers of individual MESBICs; and (2) to decrease the flow of private funds into the MESBIC program by increasing the risk of loss to equity holders of individual MESBICs.

#### *The Business Environment*

There are literally a myriad of economic factors which affect the operations of SBICs and MESBICs, many of which are outside the

<sup>17</sup> See 13 C.F.R. § 107.808.

sphere of control exercised by the SBA. There is no doubt that prevailing economic climates will dictate the disposition of certain investment decisions and we are acutely aware of the fact that during the 18 year history of the SBIC program there have been at least four clearly discernable major recessions. In addition, between 1958 and 1975, SBA advised the Subcommittee, our economy has witnessed the following events:

- GNP has more than tripled;
- Government spending has more than tripled;
- The value of the dollar has been cut in half;
- There are 40 million more people in the United States;
- The Federal Government has run a deficit in 16 of the 18 years for a cumulative amount of \$183.1 billion;
- Moody's Triple-A bond yield has moved from a 4% level to 9%; and
- Government outstanding debt has increased \$293.7 billion.

There is no easy way to ascertain the total impact of these economic changes but we must, of course, assume that SBICs and MESBICs have been dramatically affected by their occurrence.

Many of the witnesses were critical of the nature and extent of Governmental intrusion into the economy. The most critical of these witnesses, Schooner Capital Corporation, presented the Subcommittee with numerous suggestions ranging from reforming antitrust and bankruptcy laws to mandating that 50% of all Government funded programs be "set-asides" for small business. Vincent Ryan, President of Schooner Capital, cautioned the Subcommittee: "We see today an economic environment that is destroying the middle class (small business), encourages the poor to retain its status quo and concentrates the wealth and accompanying power in fewer and fewer hands."

Gulf South Venture expressed similar concern:

Today, however, the trend is moving away from free enterprise to a more state regulated economic system and to large concentrations of economic power. With this change in direction, increased restrictions are being placed on the entrepreneur's mobility by government and big business. In addition, financial incentives which stimulate economic growth are rapidly diminishing through high rates of federal, state and local taxation. If this trend continues, we will be facing a serious situation in which the free entrepreneurial spirit will be substantially destroyed. This will have an adverse effect on the nation's standard of living and, more importantly, it will take away the core that makes America what it is.

The most common criticism voiced by the witnesses concerned taxation. The witnesses called for tax reform which would, among other things, eliminate the double tier of taxation now levied upon the corporate SBIC and, subsequently, on its shareholders when certain types of earned assets are distributed. The witnesses called for a system which would allow capital gains and ordinary loss to pass through to the shareholders of SBICs and MESBICs.<sup>18</sup>

<sup>18</sup> Pursuant to Public Law 94-305, June 4, 1976, SBICs may be formed as limited partnerships. Future SBICs so organized may, indeed, avail themselves of these tax benefits.

Another common criticism was "over-regulation." SBA did admit that regulations have not kept pace with economic realities:

The overall changes in venture capital financing to small business over the last 15 years have been dramatic. As indicated previously, the legislative changes to the statute have been numerous, but have not necessarily taken into account the overall methods of operations necessary to operate an SBIC profitably. Thus, it is believed that a certain amount of regulatory "anachronism" has occurred in that the statute and the regulations promulgated thereunder have not kept pace with the actual changes in the venture capital operational field.

Many of the witnesses complained about SEC regulations and, in effect, informed the Subcommittee that such regulations were preventing the obtainment of certain program goals. Suggestions were received which ranged from a liberalization of SEC Rule 144 to a complete removal of all SEC control over SBICs and MESBICs.

In addition, FNCB Capital Corporation and NASBIC complained of SBA's small business size standards with respect to eligible investee firms. FNCB labeled the standards "arbitrary" and NASBIC testified, "We feel that the SBA general size standards are aimed at the very small firms and often prohibit us from assisting those firms which would have a major impact on competition and increased employment." SBA explained the problem this way:

Recent trends have indicated that SBICs are tending to finance larger deals. In this area, the question of what is a small business or medium size business has become fuzzy. High technology businesses or manufacturing or service businesses that are capital intensive are having difficulty in qualifying for financing under current SBA size standards requirements. There are firms that employ hundreds of people, yet cannot obtain equity financing through the normal equity market channels. These firms are small within their own industry, but because of the complexity and peculiarities of SBA size requirements may not be able to receive financing from SBICs. In addition, if there are small firms that may be affiliated directly or indirectly with larger businesses, they may automatically be placed in a large business category, making them ineligible for financing from the SBIC. A question of size thus becomes an important problem in the overall solution to an SBIC's profitability difficulties. More important, however, it becomes a problem for the Nation if those businesses on the higher end of the small business spectrum do not get financed when those businesses are the innovative and creative elements of the business world.

FNCB Capital Corporation noted another SBA regulation which it believes adversely affects the liquidity of small business securities. Russell Carson, President of FNCB, explained:

The SBIC Regulations prohibit SBICs from purchasing securities from a seller other than the issuer unless such



purchase is a reasonably necessary part of the overall sound financing of the company. Effectively, this prohibits SBICs from purchasing secondary shares in the public market or from a third party, transactions which are commonly engaged in by non-SBIC venture capital firms. Allowing SBICs some latitude in this area would benefit the national interest by providing greater liquidity to all individuals and institutions who purchase small company securities. Part of the reason it is so difficult for smaller companies to obtain public capital is the fear of potential purchasers that they will get "locked in" to a small company with a small market float and limited trading. SBICs could help create a more efficient market mechanism for smaller company securities. Additional flexibility in the Regulations would also serve to make the SBIC program more attractive to new participants. I would recommend that the Regulations be amended to allow SBICs to utilize up to 20% of their assets in the purchase of small company securities from non-issuers without restriction.

Some witnesses also expressed general complaints about the Government actually being in competition with private business concerns. In fact, one witness, Schooner Capital, testified, "Our company has two investments in the State of New York where the United States Government is the largest factor in the industry." In the money market the influence of the Government becomes most apparent. Gulf South Venture commented, "Although private business has historically provided 80% of American jobs, the Government has been borrowing about 80% of the credit available and has been taking 50% of the equity capital available."

In recognition of the tremendous demand for venture capital and the myriad of complex issues which affect its availability, SBA has recently formulated a "Task Force of Equity and Venture Capital." We were informed that this Task Force would consist of "investment bankers, venture capitalists, small business persons and others who will analyze venture capital from a knowledgeable private sector, market oriented perspective."

#### *Minority Business Environment*

There is little doubt that minority and majority owned businesses cannot be considered a homogeneous group. There are unique factors affecting minority businesses which must be considered and addressed in a specialized manner. SBA concedes that minority owned businesses do face special problems in obtaining venture capital. According to the agency some of those problems are:

Since the minority businessman lacks the business longevity of his majority counterpart, outside of mom-pop operations, he does not have the broad capital base, accumulated assets, experience, goodwill, etc., to attract additional investors or financial institutional aid.

The minority businessman does not produce enough profits to attract and pay highly qualified workers.

The minority businessman does not have the backing of the minority community.

There still remains a bias in the financial community toward the minority entrepreneur.

Dr. Knight has conducted several analyses of the MESBIC program as a vehicle for achieving the economic development of minority business enterprise. He informed the Subcommittee that the Federal effort to assist minority enterprise has been inadequate: "The Federal Government's unfocused program to assist minority enterprise has led minorities to enter industries which they tended to enter without Federal assistance." Therefore, Federal efforts have not ameliorated present factors which tend to relegate minority enterprises to small retail and service businesses. We are advised that larger minority firms not only provide more jobs for minority persons and increased employee benefits but that such firms also "offer a lower probability of failure." Dr. Knight referred to a study which tended to confirm this proposition: "In a study of 550 Black firms which had received loans from banks or the SBA, it has been found that firm size, measured by the logarithm of total assets, was inversely related to the probability of default."

Dr. Knight added that, "It is imperative that efforts to build minority enterprise be focused on the development of larger rather than 'mom and pop' firms." The average MESBIC investment per small business is estimated to be only \$21,500—an amount which is insufficient to meet the capital demands of the larger growth oriented minority businesses. Dr. Knight explained:

Recent proposals regarding minority enterprise entry into growth industries, especially technology-intensive ones, would permit the most economic benefits to minority enterprise. Thus it is useful to examine the ability of the *MESBIC* industry to fund such ventures.

A study by Dorsey of 367 such investments reveals that those resulting in very successful growth ventures averaged \$851,000 each, while those which produced failures averaged \$407,000 each. Because of statutory limitations on maximum investment size as a function of private capital invested, there are no *MESBICs* which can make investments over \$407,000 or more, much less the larger investments which are needed to finance the most successful ventures.

Dr. Knight also advised the Subcommittee of the critical demand for equity capital by minority businesses:

There has been several efforts to increase the availability of debt capital for minority enterprise. However, debt capital must be paired with an adequate equity "cushion" to minimize financial risk which can occur from an inordinately high debt-to-equity ratio.

However, we were informed that minority business is extremely limited in its search for critically needed equity:

Equity capital for minority enterprise must necessarily come from sources external to the minority community. An examination of the financial characteristics of the Black community reveals the inability of that community to provide equity capital: In 1969 Blacks constituted 11% of the total population, yet received only about 6% of aggregate income; owned only about 2.5% of accumulated equity in homes, busi-

nesses, and farms, while their share of financial assets was approximately 0.7% of the total.

The most important function of the MESBIC program thus becomes evident: to provide equity capital to be used with debt capital which has recently become available for minority enterprise development.

Dr. Knight, however, asserts that the overall size of the program is too small to make equity capital available to the minority community in sufficient amounts. The SBA agrees with this conclusion:

In our estimation the MESBIC program at its present size level cannot satisfy the minority business need for venture capital. A whole spectrum of institutional changes are necessary including tax incentives and regulatory changes in all areas affecting small business. SBA's present Task Force in Equity and Venture Capital is intended to specifically address these problems and suggest solutions.

Dr. Knight recommended, among other things, that the equity base of minority owned banks be increased, that the individual as well as the entire MESBIC program should also be expanded and that incentives be devised for MESBICs to invest more of their funds as equity capital. The witness, however, added a caveat to his recommendations:

These recommendations are not directed toward specifying amounts of capital needed for minority business development. It is obvious that current availability of capital is totally inadequate. However, political constraints suggest that it is unlikely that a suitable level of capital will be made available in the near future. Thus it is more realistic to recommend that capital availability be expanded significantly and to expect that political realities will halt or reduce such expansion well before any recommended levels of availability are reached. Political constraints arise from those public and private institutions which compete with proponents of the *MESBIC* program for the finite supply of total available capital.

Of course, the vitality of the minority business community is based upon a myriad of factors and the availability of capital is only one such ingredient. We were told by Space Ventures, Inc. and others that the MESBIC program is not a panacea for all economic and social ills besetting the minority business community.

It should also be noted at this point that the MESBIC program is actively promoted by the Office of Minority Business Enterprise (OMBE). This office contacts major corporations and others in an attempt to interest such parties in the program. OMBE will help prepare license application forms and participate in meetings between the interested party and SBA. In addition, OMBE funds certain activities designed to provide management assistance to MESBIC operators as well as to investee companies. The office does, in addition, facilitate the referral of potential investee firms to MESBICs. Testimony received from MESBICs which have utilized OMBE's services was laudatory.

Both SBA and OMBE advised the Subcommittee the level of their mutual cooperation was most satisfactory.

### Government Costs and Benefits

As an integral part of its review the Subcommittee undertook an attempt to measure both the costs and benefits of the SBIC and MESBIC programs.

We were told that between 1958 and 1967 the SBA had not "charged off" any losses due to the SBIC program. Commencing with 1967 and continuing through May 31, 1976, there has been a total of \$22 million in actual losses sustained by the agency. To date, SBA has not "written off" any loss attributable to the MESBIC program.

#### EXHIBIT XXVII

##### SBIC PROGRAM—CHARGEOFFS BY FISCAL YEAR, BY TYPE OF RECEIVABLE

	Debentures	Loans	Judgments	Other <sup>1</sup> receivables	MESBICS	Preferred stock	Total
1967	\$10,201.68				0	0	\$10,201.68
1968			\$49,619.29		0	0	49,619.29
1969	769,174.66	\$28,820.01	2,500,549.54			0	3,298,544.21
1970	2,014.95		3,697,436.41	\$100,729.63	0	0	3,800,181.19
1971	300,000.00	345,910.75	3,949,517.19		0	0	4,595,427.94
1972			241,433.85	285.56	0	0	241,719.41
1973	150,470.41	239.81	2,092,647.92	284.89	0	0	2,243,643.03
1974	255,922.05		4,219,537.64	13.84	0	0	4,475,473.53
1975	197,577.72	280,097.84	1,605,486.90	89,951.98	0	0	2,173,214.44
1976 (May 31, 1976)		706.45	952,210.91	207,321.19	0	0	1,160,238.55
Total	1,685,461.47	655,774.86	19,308,439.65	398,587.29	0	0	22,048,263.27

<sup>1</sup> These are chargeoffs of amounts due from guarantors or others with whom arrangements had been made for payment relating to SBIC loans or debentures.

In addition to the \$22 million actually written off, SBA has established a reserve for expected future losses of approximately \$26 million. The SBIC and MESBIC portfolio is evaluated yearly by SBA in order to determine what losses can be anticipated, given the present level of financing, and the economic stability of the individual SBICs and MESBICs. Over the life of the program, actual losses and reserves for losses on SBA debt have been about 7% of the SBA funds disbursed.

In addition to losses sustained because of SBA's purchase or guarantee of SBIC securities, the agency has also incurred certain administrative expenses directly attributable to the program. SBA testified that, "During the past five years the Investment Division has operated with between 35 and 41 positions at an administrative cost of about \$900,000 per year, excluding support functions, legal, examiners, investigators, etc."

The SBA does receive income from both the SBIC and MESBIC program operations.<sup>10</sup> Most income is received through interest earned on SBIC and MESBIC loans and debentures. The agency also collects various fees, including those for licensing and examination. In rarer instances SBA also realizes certain "profits" from the sale of assets acquired subsequent to liquidation of an SBIC or a MESBIC. In total, the income received by SBA since the inception of the program is represented in the following Exhibit:

<sup>10</sup> SBA's accounting procedure does not differentiate income received between SBICs and MESBICs.



## EXHIBIT XXVIII

*SBICs and MESBICs income earned by SBA by fiscal year*

Year:	Income received	Year:	Income received
1959 -----	\$1, 376. 16	1970 -----	12, 171, 024. 43
1960 -----	131, 198. 21	1971 -----	15, 112, 611. 26
1961 -----	725, 440. 85	1972 -----	15, 340, 042. 46
1962 -----	2, 329, 668. 98	1973 -----	14, 971, 176. 65
1963 -----	5, 142, 962. 00	1974 -----	13, 688, 969. 47
1964 -----	7, 919, 300. 22	1975 -----	14, 948, 384. 46
1965 -----	10, 471, 115. 66	1976 -----	15, 142, 217. 59
1966 -----	11, 476, 197. 03		
1967 -----	8, 665, 347. 37	Total -----	\$169, 663, 158. 96
1968 -----	9, 737, 247. 86		
1969 -----	11, 688, 878. 30		

Apart from the income derived by SBA we are told there are many other benefits received by the Government as a result of the program.

SBA estimates that 25 jobs are created per small business financed by a regular SBIC and 16 jobs are created per small business financed by a MESBIC. It is estimated, NASBIC informed the Subcommittee, that 720 new financings between March 1974 and February 1975, have added nearly 13,000 people to the employment rolls. Gulf South Venture estimates that it creates a job with every \$5,000 of investment.

Aside from jobs created, the Subcommittee was informed, the Government has received substantial tax benefits. FNCB Capital Corporation commented:

The Federal Government is a direct beneficiary of the SBIC program in that it collects income taxes from the successful investee companies, payroll taxes from the persons holding new jobs which are created by the companies, and income and capital gains taxes from the SBICs and other shareholders in successful ventures.

NASBIC also advised the Subcommittee that businesses financed by SBICs and MESBICs have served to better our economy through increased competition and lower prices for consumers.

Dr. Komives indicated that the "SBIC industry has (in addition) spawned a private sector spinoff" thereby increasing both the availability of venture capital and competition *within* the venture capital industry.

SBA has made an analysis of the SBIC and MESBIC program covering the 15 year period between 1960 through 1974. On the basis of this study the agency concluded:

The benefit cost ratio for the SBIC program is quite high. \$34 of present value is added to the economy for each cost dollar the Government spends on the SBIC program

When Chairman Addabbo asked the agency whether the SBIC and MESBIC programs are achieving their intended statutory purpose SBA replied, "Yes, but only within the relatively small scale of their operations within the context of the Nation's total economy." Despite the ascertainable benefits derived, there was no indication by any witness that the program had reached its full potential.

## CHAPTER III. CONCLUSIONS

The SUBCOMMITTEE CONCLUDES that the statutory purpose of Title III of the Small Business Investment Act of 1958 was to provide a source of equity and long term debt capital to small business. The Congress further decided it would be best to achieve this purpose through the maximum utilization, or leveraging, of private capital and management resources.

The statute demonstrates a clear preference for equity financing as opposed to debt and, in fact, considers this latter type of financing of subordinate importance to be used in limited circumstances. Further, the Act does seem to equate "equity" with venture capital.

WE CONCLUDE, however, that venture capital is a function of risk and not the nomenclature affixed to a security. While it is generally true that equity is a higher risk investment than debt, this is not a universal tenet. The Subcommittee cannot offer precise definitional boundaries which characterize a certain level of risk as falling within the category of venture capital. But we can conclude that venture capital is high risk capital normally not made available by banks or similar institutions, which, in addition, is not obtainable through traditional public underwritings, and which the investor provides, full well realizing that his or her investment is, at best, a calculated chance. Therefore, the true venture capitalist does expect loss (unlike a banker) but, in addition expects to reap substantial gains from a few investments to cover such losses and realize profit. Typically, the venture capitalist takes an equity position, hoping that the company will grow and eventually become publicly traded. Return on investment, therefore, is anticipated to take the form of capital gains.

For reasons which will be stated below the SBIC and MESBIC is not totally suited for such investment policies. It is a hybrid in the financial world subject both to the dictates of economic reality and government regulation not attended to by its private sector counterparts.

WE CONCLUDE that there is a dramatic present and future need for venture capital although the precise dollar amount of such need cannot be clearly defined with any certainty. The evidence also established that for many small businesses SBICs are the only available source for equity capital and this situation is most true for those small businesses owned by minority individuals. The Subcommittee believes, however, that this need has only been slightly impacted by SBICs and even less so by MESBICs. Therefore, WE CONCLUDE that the Congressional objectives recited in the statute have not been fully realized.

The SUBCOMMITTEE CONCLUDES in addition that many of the SBA's rules and regulations pertaining to the program are inadequate. For example, the regulatory definition of *venture capital* includes subordinate debt but the statute mandates that all debt must have a *reasonable assurance of repayment*—an evident contradiction. Further, the regulations define equity securities to include debt with some future equity right *or* debt which may be subsequently converted into equity. This definition is unique to SBA; the private business sector does not abide by such a definition and the Subcommittee is at a loss to determine why the agency does so.

Perhaps the most severe deficiencies in SBA's regulations affect MESBICs. MESBICs can sell 3% cumulative preferred stock to SBA as part of its leverage. The statute and the regulations state that if a MESBIC, so leveraged, makes a distribution to its shareholders SBA "may require" payment of the difference between the dividends it has received on the preferred stock to date, and cumulative dividends payable at a rate equal to the interest rate comparable to outstanding marketable obligations of the United States, which bear a 15 year term, at the original time of financing. The specific circumstances when SBA "may require" such differential payments is not defined. MESBICs with preferred stock leverage, therefore, operate with considerable uncertainty which thereby discourages potential MESBIC investors.

Similarly, the statute authorizes SBA to purchase MESBIC debentures which for the first five years of their term bear an interest rate which is the greater of either 3%, or 3% below the commonly affixed interest rate determined by the Secretary of the Treasury, by taking into account the interest rates of United States obligations of comparable maturities. SBA interprets this provision to be a deferral of the 3% differential while the MESBIC industry believes it was intended to be a nonrecoverable subsidy. **WE CONCLUDE** that the statute is defective in this regard and should be amended to clearly characterize the nature of this differential. However, SBA's present interpretation is well within its legal bounds although we believe it should be carefully reviewed, taking into account its effect upon MESBIC profitability and incentive to potential MESBIC investors.

The Subcommittee is greatly concerned with the apparent lack of equity investments made by SBICs and MESBICs. Reasons cited for such inactivity included: (1) The cost of money; (2) the illiquidity of small business stock; and (3) tax provisions which allow loss on debt to be written off as ordinary loss.

**WE CONCLUDE** that the ability of an SBIC or MESBIC to make equity investments is, in part, dependent upon its cash flow requirements needed to service its own debt. But, we also note that the size of an SBIC or MESBIC is positively correlated with its propensity to provide equity financings. Further, the evidence was clear that there is a positive relationship between SBIC size and the number and size of its individual financings as well as the SBIC's overall potential for success. SBA has set an administrative minimum of \$500,000 as private paid-in capital for regular SBICs. MESBICs, however, may still be licensed if the statutory minimum of \$150,000 of private paid-in capital is committed. **WE CONCLUDE** that the statutory minimum is totally inadequate to provide any reasonable prospect of success for the individual SBIC or MESBIC and that such minimum amounts will not produce the statutorily desired financing to small businesses.

**WE FURTHER CONCLUDE** that the illiquidity of small business stock may, in certain circumstances, inhibit SBIC and MESBIC equity investments. We do not have data which indicate how pervasive this situation is. SEC Rule 144 was often cited as a regulatory barrier inhibiting equity investment by SBICs and MESBICs. The purpose of the SEC is to protect the investing public and the intent of the SBIC/MESBIC program is to assist small business. We do not view these

goals as incongruous and believe it is incumbent upon both the SBA and SEC to reconcile the execution of their respective functions.

The Subcommittee was greatly dismayed to discover that some SBICs and MESBICs may be engaging in activity inimical to small business in an attempt to overcome the illiquidity problem associated with small business stock. Such activity can include SBICs and MESBICs receiving stock from an investee business accompanied by a "repurchase agreement" mandating that the stock be repurchased by the firm in the future—at a price and at a time determined in accordance with the agreement. When exercised, the repurchase may severely impair the operating capital of the small business or the small business may be forced to secure debt in order to purchase back its stock. Alternatively, the SBIC or MESBIC may sell the stock to a large business concern which can then integrate the small concern into its operations. WE CONCLUDE that both types of situations are completely contrary to the letter and spirit of the Small Business Investment Act and we urge SBA to closely monitor any situation where a repurchase agreement is executed or where a sale of small business stock to a large concern will give that concern control over the small business.

Many witnesses complained that present tax laws do not favor the corporate venture capitalist. The Subcommittee was urged by the SBIC and MESBIC industry to promote tax legislation which would make equity investments more attractive. In effect, the industry desires that all gain from equity transactions be treated as capital gains, all loss treated as ordinary loss and that SBICs and MESBICs be allowed to "pass-through" such loss and gain directly to its shareholders. While it is, of course, true that such a shift in present tax laws would prove beneficial to SBICs and MESBICs, we are not prepared to endorse any such recommendation without a detailed showing of necessity and an analysis of the Government cost involved. We were not presented with such justification. We do note, however, that some of these tax benefits may be derived by SBICs which form as limited partnerships pursuant to P.L. 94-305 (June 4, 1976).

The Subcommittee is cognizant of the problems that SBICs and MESBICs face in making equity investments. But, we do note that some SBICs and MESBICs are established for the sole intended purpose of making relatively small loans at the maximum allowable interest rate. This is clearly not the intent of the statute and we believe SBA should not issue a license to any individual or organization which demonstrates such an insular motive.

WE CONCLUDE that MESBICs do not generally finance minority owned businesses with the highest growth potential but instead tend to finance small retail or service businesses. The program, therefore, has not proved effective in removing the minority business person from the traditional types of businesses to which he or she has been relegated. The potential for financing larger operations is dependent upon the MESBICs' size and since most MESBICs have been permitted to operate at a low level of capitalization, the present situation is not only understandable but is to be expected.

We also believe that minority owned businesses suffer from a severe lack of equity capital and the primary focus of the MESBICs should be to alleviate this problem. However, WE CONCLUDE that even



if the capitalization of all MESBICs were fully invested in equity financings, the impact on the total demand would still be relatively slight. It is apparent that the size of the program must be increased as well as the size of the individual MESBIC.

We note with concern that some MESBICs have been formed by large corporations for merely social reasons. We strongly believe that SBA should not license any MESBIC which demonstrates this motive as its sole purpose. Those MESBICs operating only with a social incentive may well lack sound business judgment and, from the inception, view its financings as mere "write-offs." Such an attitude is injurious to the investee company which in many cases may be underfinanced, and/or left on its own to flounder and thus fulfill the MESBIC's expectation of loss. We cannot rightly expect that true economic development can be based upon other than true economic motivations. Social consciousness, in this context, often leads to paternalistic endeavors which impose and cement different business systems for persons of different ethnic backgrounds. We view the potential of the minority business community as a virtually untapped natural resource and therefore we seek not the satisfaction of perceived social obligations but the true development of all our natural resources for the benefit of all our people regardless of ethnicity.

When the Subcommittee undertook the present investigation it attempted to determine, among other things, the full economic benefits which accrue to the SBIC and MESBIC shareholder. Our motivation was to assess the true profitability of the industry. WE CONCLUDE, however, that there is not available any reliable data whereby we can measure the gains realized by such shareholders.

We are informed of extremely complex financing arrangements, the "passing-through" of small business securities to SBIC and MESBIC shareholders, SBICs and MESBICs subsidized by parent concerns and other similar action which may escape SBA's scrutiny. It is apparent that the Government has created a billion dollar industry which has outdistanced the ability of SBA to monitor fully. The innovation in the financial sphere rivals that of any industry and we concede that such innovation can easily outpace bureaucratic resources, which by nature tend to be static.

There has been much controversy about the MESBIC program concerning the question of idle funds. WE CONCLUDE, however, that idle funds are a function of several different factors including the MESBIC's expenses and concomitant cash flow requirements; the time during which it has been in existence; reserves for secondary rounds of financing; reserves for new financings; and individual investment policies. We believe it imperative that SBICs and MESBICs retain liquid funds in reasonable amounts to service legitimate needs. We are not prepared to specify percentages since an adequate level of idle funds will, by necessity, vary with each individual SBIC and MESBIC. The relevant inquiry is whether an SBIC or MESBIC is acting in good faith to fulfill statutory purposes. A high level of idle funds is an indication of inactivity but is not conclusive. However, we do believe that since approximately 50% of total MESBIC funds are not invested, there is sufficient reason to assume that at least some MESBICs are not in pursuit of legitimate statutory purposes. It is difficult to believe, as some MESBICs claim, that the economy is not producing

sufficient investment opportunities which are suitable for their financings.

WE CONCLUDE that the SBA has received a dramatic return on the funds it has committed to the SBIC and MESBIC program. There is no doubt that the program has been highly cost effective for the agency.

In addition, the operations of the program have yielded tax benefits to the Government and increased participation of small business in the economy. Further, the program has "spun-off" a private venture capital sector with its resulting economic benefits. The SUBCOMMITTEE FURTHER CONCLUDES that the SBICs and MESBICs have been responsible for creating substantial employment opportunities.

We note with serious concern, however, that SBICs and MESBICs do not, generally, finance small, high-technology start-up businesses because of the risk involved and the inability of such concerns to service debt. Such businesses have a critical demand for equity capital which, in today's economy, goes virtually unsatisfied. The evidence established, however, that such concerns have a potential for creating jobs which is unparalleled by other types of business endeavors. Further, failure of the economy to finance the small high-technological start-up will relegate the discovery and production of new technological products to large businesses, further increasing their economic dominance.

We are aware of the fact that the SBIC and MESBIC programs cannot be studied in isolation of the environment in which they must function. Small business today is becoming an endangered economic entity. It is with increasing rapidity that the resources of production gravitate toward dominant businesses and interests. As wealth accumulates, momentum builds and the small business becomes a victim inescapably caught in this economic vortex.

The Government is responsible for checking this situation and is bound by statute to protect and foster small business. Yet, we find situations where the Government itself operates in contravention to its own established mandate.

The present economy militates against the potential for small business success. Our goal is to investigate and initiate remedies for those destructive factors whether they lie in Government or are external to it. It is our hope that the SBIC and MESBIC program may be fully developed as an effective tool in this struggle.

#### CHAPTER IV. RECOMMENDATIONS

On the basis of all evidence received, further investigation by the Subcommittee, and the review of all available data, the Subcommittee recommends:

##### A. That the Small Business Administration:

- (1) Expand and make more timely its data base of information concerning the operations of SBICs and MESBICs. The informational system should be improved so that SBA can readily measure, in so far as is practicable, the extent and effect of security "pass-through" situations, "mandatory buy-back" provisions, management services provided to investee firms, and the terms

of all financing arrangements. Further, SBA should devise a data gathering system which would indicate the level of activity pursued by an SBIC or MESBIC in seeking new investment opportunities.

(2) Conduct an extensive review of its rules and regulations with primary emphasis on its definitions of "equity" and "venture capital financing." In addition, the rules should be amended to clearly reflect in what situations SBA will require the payment of any differential amounts by leveraged MESBICs making distributions to its shareholders. Moreover, size standards should be reviewed as well as eligibility criteria of potential MESBIC investee firms, to reflect consideration of those persons who are disadvantaged because of sex discrimination.

(3) Not license any MESBIC which has for its *sole* intended purpose the satisfaction of its perceived social obligations.

(4) Give serious consideration to administrative change which would preclude the licensing of any SBIC or MESBIC that does not have a combined private paid-in capital and paid-in surplus of at least \$1,000,000.

(5) Assure, as far as possible, that a function of each SBIC and MESBIC is to provide equity capital to small business, as is required by Section 304(a) of the Act.

(6) Engage in all appropriate effort to assure that the recipients of MESBIC assistance are economically or socially disadvantaged.

(7) Conduct a study of the MESBIC program for the purpose of establishing specific program objectives. Such a study should include an assessment of venture capital needs by minority business, and proposed means for providing larger equity injections in those minority businesses which have the highest growth potential. The MESBIC program should be evaluated in terms of how it can best service these needs and what, in addition, is required to strengthen its impact. This study is to be accompanied by such recommendations for legislative and/or regulatory change as may be deemed appropriate.

(8) Conduct a study of the peculiar problems encountered by "start-ups" in obtaining venture capital with specific emphasis on the "high-technology" oriented small concern. This study is to be accompanied by such recommendations for legislative and/or regulatory change as may be deemed appropriate.

(9) Conduct a study, in cooperation with the IRS and SEC, on the various aspects of tax and securities laws or regulations which may unreasonably hamper SBICs or MESBICs from achieving the purposes of the Small Business Investment Act of 1958. This study is to be accompanied by such recommendations for legislative and/or regulatory change as may be deemed appropriate.

(10) Forward to this Committee its response to the above recommendations by February 1, 1977.

**B. That the Office of Minority Business Enterprise and the Small Business Administration:**

Continue all appropriate efforts to coordinate their respective activities with respect to the MESBIC program. In addition,

SBA should encourage MESBICs to utilize OMBE's services and OMBE should exert every effort to attract the initiation of new profit-oriented MESBICs.

C. That appropriate Committees of the Congress consider legislation that would—

(1) Raise the private paid-in capital and paid-in surplus requirements of both SBICs and MESBICs to \$1,000,000.

(2) Allow SBA, at its discretion, to conduct audits of small businesses financed by SBICs and MESBICs.

(3) Redefine the terms "venture capital" and "equity capital" as commonly employed by the financial community.

(4) Provide that debentures purchased by the SBA pursuant to Section 317 of the Act are to bear a pure and permanent interest rate subsidy for the first five years of their term.

(5) Clearly specify when SBA must be paid any differential costs by a leveraged MESBIC which makes a distribution to its shareholders. It is suggested that future legislation permit leveraged MESBICs to make limited distributions to its shareholders provided that such distributions are paid from retained earnings and will not impede the MESBIC's ability to comply with all other statutory provisions.

(6) Provide more personnel for the SBA to be assigned exclusively to its Investment Division.

(7) Amend Section 301(d) of the Act to disallow the organization of MESBIC's as nonprofit corporations and to allow MESBICs to form as limited partnerships.

D. That the President and the Congress give due recognition to the fact that SBA programs have a high potential for creating jobs at a relatively slight cost to the Government. Initiative for creating new employment opportunities should involve consideration of SBA programs, such as SBICs and MESBICs, which generate jobs through the use of funds loaned by the SBA or obtained through its guarantee.



SRH should encourage JMSHC to utilize CMRE's services and QMB should exert every effort to attract the initiation of new grant-oriented MEHB's.

C. That appropriate committees of the Congress consider legislation that would—

(1) Increase the private paid-in capital and public capital requirements of both SRHC and MEHB's to \$1,000,000.

(2) Allow SRH, at its discretion, to contribute to the establishment of SRHC's and MEHB's.

(3) Include the terms "venture capital" and "venture capital" as commonly employed by the financial community.

(4) Provide that the Federal Government, pursuant to the SRH, contribute to section 317 of the Act to provide a grant and technical assistance to the SRH for the first five years of its term.

(5) Clarify specifically when SRH should be paid and when it is not by a Federal MEHB, which makes a determination to its satisfaction. It is suggested that SRH be paid for the first five years of its term.

(6) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(7) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(8) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(9) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(10) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(11) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

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(13) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.

(14) Amend JMSHC to make limited liability to the SRH, to the extent that the SRH is not a partner in the SRH, to the extent that the SRH is not a partner in the SRH.